VENTURE CAPITAL FINANCING VIA SBIC'S AND MESBIC'S

HEARING

BEFORE THE

SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

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VENTURE CAPITAL FINANCING VIA SBIC'S AND MESBIC'S

TUESDAY, NOVEMBER 23, 1982

House of Representatives, Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems, Committee on Small Business,

San Francisco, Calif.

The subcommittee met, pursuant to call, at 10:30 a.m., in the Ceremonial Courtroom, U.S. Court House, 450 Golden Gate Avenue, San Francisco, Calif., Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN MITCHELL

Mr. Mitchell. The hearing will now come to order. I must say that since I have been in the Congress I have found field hearings to be the most effective way of gathering important information for evaluation of governmental programs.

This morning the subcommittee is pleased to convene in San Francisco. The topic of today's hearing is venture capital for small businesses, particularly through programs administered by the Small Business Administration.

In 1953, the Congress clearly recognized the needs of small businesses to obtain Federal financial assistance in order that it might prosper and grow. That year the Congress enacted the Small Business Act which provides financial assistance through an SBA administered loan program. Although this program was highly successful in promoting small business and contributed to the establishment of a more balanced national economy, it soon became apparent that the financial needs of the small business community involved more than simply loan capital.

Clearly the small business community needed what we now call venture capital. As a result, in 1958, Congress enacted the Small Business Investment Act which authorizes SBA to license private companies called Small Business Investment Companies whose sole purpose would be to make investments in small businesses either through long-term subordinated loans or through the purchase of stock or a combination of these. These licensees, in essence, would form a partnership with the Federal Government.

The private company—the SBIC—would provide the basic or initial capital and the Government would contribute matching funds to the SBIC under a formula involving the amount of private capital invested in the SBIC and the nature of the investments the SBIC makes in the small business community.

Like any other new program there have been some problems with this one. However, in the overall, I think it has been highly successful and I think most of the Members of Congress would agree with that. In the 23 years the SBIC programs have been in operation, the SBIC industry collectively has provided financial assistance in the form of long-term subordinated loans or in the form of equity to more than 61,000 small businesses for a total of $4.2 billion. Subsequently, it was also recognized that the Government should facilitate and encourage SBIC's to invest more in minority small businesses.

As a result, a special class of SBIC's was authorized by law and these specialized loans were commonly called Minority Enterprise SBIC's, or MESBIC's. In the 12 years since these specialized companies were authorized and licensed, they have provided financial assistance to almost 5,000 minority concerns for a total of over $250 million.

The combination of these programs has provided financial assistance of more than $4.4 billion to over 66,000 small businesses in the United States. The total Federal investment in the SBIC and MESBIC industries which supports this huge investment amounts to $1.7 billion, and it has been a highly cost-effective investment for the Federal Government.

To date, the Small Business Administration has incurred losses of $31.2 million, or less than 2 percent of the entire amount provided to SBIC's and MESBIC's. This is one of the best loss rates of any Federal program designed to assist the small business community.

When you look at it another way, according to an independent study released last year, companies receiving the SBIC funds have created growth in employment 10 times that of other small firms and this growth has occurred at an estimated $312 cost to the Federal Government per new job created, which is relatively low. Thus, truly we may say of the SBIC and MESBIC industries that they are recognized as the Nation's job creators.

This morning's hearing will involve testimony from the SBIC's and MESBIC's and companies that these SBA licensees in turn have assisted.

We are pleased to be here, however, and I am sure that we will receive valuable information which will assist us in carrying out our role to conduct oversight on SBA programs and evaluating their performance, particularly in these times of budgetary restraint when we have seen some very, very good programs in the SBA area, regrettably, in my opinion, significantly underfunded.

I am delighted that Congressman Mark Siljander is with us. He is an outstanding member of the committee. This committee has been on the road this year. We have looked at the peso devaluation down along the Texas-California-Mexican border. We were here to look at the mud slide problems. I think we have had about five field hearings.

Congressman Siljander is always one whom we can depend upon to show up at these hearings at, I am sure, personal sacrifice. Do you have an opening statement?

Mr. SILJANDER. I would just like to hear from the people, Mr. Chairman.

Mr. MITCHELL. Again, thank you for taking time out to be with us.

We would like to call up our first panel now and that would be Robert F. Zicarelli, chairman of NASBIC and chairman of the Northwest Growth Fund, Inc. in Minneapolis, and Mr. Luther Prince, president of Ault, Inc. in Minneapolis. If those two witnesses would come forward we will be delighted to receive your testimony.

Thank you for being here, gentlemen. It is always tough to leave the store, and the only reason I am here is that Congress is not officially in session. If it were in session I wouldn't dare be away from Washington, D.C.

I only called two names. Whom am I missing up there? Mr. McNeish?

Mr. MCNEISH. Peter McNeish with NASBIC.

Mr. MITCHELL. Fine. We have copies of your testimony. You may proceed in any order that is most convenient for you.

PANEL CONSISTING OF ROBERT F. ZICARELLI, AND LUTHER T. PRINCE, JR.

TESTIMONY OF ROBERT F. ZICARELLI, CHAIRMAN, NASBIC, AND CHAIRMAN, NORTHWEST GROWTH FUND, INC., MINNEAPOLIS, MINN.

Mr. ZICARELLI. Fine.

Mr. Chairman, it isn't quite as much of a chore to leave Minneapolis at this time of the year as it might be from some other climate.

Mr. Chairman and members of the committee, I am Bob Zicarelli, chairman of the Northwest Growth Fund of Minneapolis. I am also serving this year as chairman of the National Association of Small Business Investment Companies, the trade association which represents most licensed small business investment companies and minority enterprise small business investment companies. We are proud of our industry, and of the job we are doing to help the Nation's growth-oriented small businesses.

On the other hand, we realize that every program, including ours, has its problems. We are grateful to the committee for taking this time to constructively examine the SBIC industry. I think we all agree that small growth companies will play a vital role in our economic recovery, and that a healthy venture capital community is essential to help them achieve their potential.

To the extent that we can work together to improve and expand the SBIC program and maintain high standards of operation within the industry, the country will benefit from the economic stimulation that will result.

Let me briefly discuss the SBIC I know best, Northwest Growth Fund. Our SBIC was licensed in 1961, so we have been in this exciting business of providing venture capital to small, emerging growth companies for some 21 years.

Northwest was originally organized by Northwest Bank Corp., a bank-holding company, and a dozen individuals. In those days the law restricted banks or bank-holding companies from owning more than 50 percent of an SBIC.

This ownership restriction was later changed, and Northwest Growth Fund has been a wholly owned subsidiary of the bank-holding company since 1979. Our SBIC has private capital of $10 million, of which approximately $3 million is paid-in capital by investors, and $7 million is retained earnings which have been capitalized. In addition, we have nearly $30 million of realized and unrealized gains on our books, and SBA leverage of almost $23 million. Our total assets are approximately $23 million at cost, and over $70 million at market value.

While our company is headquartered in Minneapolis, we also have branch offices in Portland, Oreg., and Denver, Colo. I am quite proud of Northwest Growth Fund's 21-year record. During this time we have invested [illegible] million, and provided substantial management counsel to 150 small firms. Our current portfolio consists of 70 businesses in which we have total outstanding investments of $36 million in cost. Our portfolio is somewhat unique because of its diversification.

For example, while a substantial number of our investments have been in Minnesota and the immediate surrounding States, our branch office system has provided us the opportunity to diversify geographically, so that we now have investments in 16 States.

Northwest Growth Fund's portfolio also reflects our management philosophy of trying to design financings to meet the needs of each small business on an individualized basis. As a result, we have provided a wide variety of types of financings to small firms, ranging from common stock to second mortgages.

Finally, our portfolio is characterized by a wide diversity in the types of firms in which we have made investments. Included in our portfolio are some very hightech businesses such as Cray Research, which is the builder of the world's largest scientific computers, and a molecular genetics and engineering company which recently received publicity for a herpes vaccine it has identified. Some other more mundane companies are included in our portfolio such as the Vee Corp., which produces a road show version of "Sesame Street," and Minitonka, Inc., which is the maker of soft soap.

Because we believe strongly in a contribution of SBIC's to the areas we serve, Northwest Growth Fund has done its own economic impact analysis. We think the results are extremely gratifying and form a record that the Government and our SBIC can look to with pride. I have submitted for the record the findings of that analysis.

There were some 52 companies in our portfolio as of December 31, 1981. Sales increases in these companies are over 300 percent, including export sales up nearly 23 times. Pretax profits of these companies are up 550 percent since we made our original investments. We have shown employment gains in these 52 companies of nearly 9,000 jobs since our original investments and taxes paid in the most recent year—including estimated withholding taxes, including those paid on payrolls of these companies—total nearly $68 million, compared to less than $20 million paid by these companies before our investment. We think that is a fairly significant contribution by these portfolio companies.

I would like to tell you that every one of our investments over 21 years in the business has been a winner, but obviously, several have not been successful.

In fact, at one point in time 15 years ago, our SBIC had a capital impairment. We needed the cooperation and understanding of our SBA partner to weather those difficult times, because such a capital impairment put us in default on the loans that we had been advanced by them.

To SBA's credit, they were patient; we turned the corner and the partnership has worked. The major beneficiaries have been a large number of small firms who have prospered and expanded in terms of sales, profits, jobs, and net worth.

Northwest Growth Fund's experience has been equally gratifying. We have had a compound annual rate of growth of more than 20 percent over the 21-year life of our company. In achieving these results we have made good use of SBA leverage, now at a ratio of slightly more than 2 to 1 to our paid-in capital.

The SBIC program is based on free-market, profit-motivated principles. I have no hesitation in telling you that is why our parent bank holding company is involved, and enthusiastic about the program. Doing business for profit they have realized a substantial return on their investment. Since our acquisition by Northwest Bank Corp. in 1979, Northwest Growth Fund has earned more than $15 million before taxes and distributed over $4 million at market value of investments to its parent company whose direct investment in Northwest Growth Fund was less than $2 million and who paid $8½ million to buy out the minority investors.

But rather than dwell on Northwest Growth Fund itself, I would like to talk to you about the industry for a moment. Over the past 23 years, SBIC's have invested more than $4 billion of equity capital and long-term venture loans in over 60,000 small business concerns, as you pointed out earlier.

Today, over 360 SBIC's with assets of more than $2 billion are actively engaged in the financing of emerging companies. In calendar 1981, SBIC's invested $33 million, and if the current financing trends continue that record will be broken in 1982. In fact, from January to June of this year a 6-month high of more than $175 million was invested in small concerns by SBIC's. It is interesting to note that increasing amounts of SBIC financing are taking the form of straight equity or equity with debt characteristics. Of the investments in the first 6 months of 1982 three-fourths were in this category.

The financing statistics and the increased number of large, new SBIC's coming to the program are clear indications that in spite of uncertain economic conditions, hundreds of venture capitalists and entrepreneurs are willing to risk their money and reputations on the ability of innovative, well managed small firms to grow and be profitable.

In an effort to determine the impact of SBIC financing on small businesses, 2 years ago NASBIC commissioned the international accounting firm of Deloitte, Haskins and Sells and the economic consulting firm of Arthur D. Little to do a data base survey of SBIC portfolios.

The survey, completed in early 1980, showed that SBIC-financed small firms experienced growth rates almost 10 times as great as those of other small companies in such key areas as sales, profits, and employment. The study also showed that the growth of Federal tax payments of SBIC portfolio companies is over five times that of all other small concerns. Incidentally, these figures are compatible with those derived from a study conducted independently by the Investment Division of the Small Business Administration.

The figures from the economic impact studies are impressive. However, the results would be worthless if the small concerns that the SBIC program was designed to promote did not value SBIC assistance.

SBA's own surveys over a period of 6 years fully demonstrated that SBIC portfolio companies place a high level of value on SBIC assistance. The portfolio companies were selected on a statistically random sample basis and responses were given anonymously in order to insure that replies were credible and unbiased. Over 95 percent of the entrepreneurs questioned said the SBIC investment was of significant importance to their firms' growth and 90 percent gave clear evidence of their satisfaction with the SBIC relationship.

Deloitte, Haskins and Sells followed up their economic impact survey with a second study designed to measure the direct cost to the Federal Government of the SBIC program and the benefits generated by SBIC activity.

They found that in 1979 Uncle Sam spent only $4 million to run the SBIC program, $2 million on administrative costs and $2 million to cover losses on loans to SBIC's. In return for that $4 million, the Federal Government received a total of $440 million in increased tax payments from SBIC's, their portfolio companies and the employees of those portfolio companies: a cost benefit ratio of 1 to 110. I have been unable to find any other Government program that can brag about that kind of performance. When Congress passed the Small Business Investment Act of 1958 it was a risky experimental program, an unusual Government-private sector partnership designed to address a public policy issue—the small business equity capital gap. Congress settled on SBIC's as private for-profit businesses after rejecting the idea of a straight Government agency or a quasi-public corporation such as RFC to do the job.

When Congress passed and President Eisenhower signed the Small Business Investment Act of 1958, four basic questions were still unanswered. Would private investors and managers put their dollars and talents to work on this enterprise?

If so, could SBIC's overcome all the odds shown in business survival data and make money in this high risk program? Would entrepreneurs and small business owners be willing to accept outside investors or partners in their closely held firms? How much money would Uncle Sam lose by making loans to these SBIC's?

More than 23 years later we have the answers to all those questions. The SBIC program has attracted over $1 billion in private capital, and hundreds of highly talented managers. The SBIC industry overall has become profitable, and many SBIC's have made a highly attractive return on their private capital. Hundreds of thousands of small businesses and would-be entrepreneurs have applied for SBIC dollars. BA surveys have shown that 95 percent of all those receiving SBIC assistance have been delighted they did so.

Finally, the Government has lost only a tiny number of dollars from defaults on loans to SBIC's. At the same time it has received many times as much from direct tax payments of SBIC's alone and increased taxes paid by portfolio companies and their employees. For all these reasons we feel the SBIC program is a proven success on every count.

I mentioned earlier the pace of new investment by SBIC's in 1981 and 1982, when nearly $700 million was invested. Leverage has helped make this pace possible as has new money and realized gains by SBIC's. As we see the leverage picture, today with the administration proposing to cut it back to $125 million, and with only $135 million of last year's appropriation of $160 million being used by SBA, and the need to fund rollovers, a present debt being at very high levels, the new money pumped into small business will decline dramatically in the years ahead. This is most unfortunate and we applaud your attempts to increase the appropriation to $250 million and speculate that even more would help us to stimulate further the pace of economic recovery.

Squeezing out has been given as a reason for cutting back funding from the Federal Financing Bank for our program. I submit, our use of funds from that source is being used to allocate the money to those companies who can use it most effectively and are least likely to receive it from normal sources. So it is really not squeezing out, but letting some people in.

In conclusion, we are grateful for the opportunity to appear at these hearings to express our views regarding the SBIC and MESBIC programs. I particularly want to commend you for inviting some of our clients to participate in these hearings because the real test of the value of this program is how well our industry serves small business and creates opportunities for entrepreneurs to build successful businesses.

The clients who have agreed to join us this morning are not the most successful companies in our portfolio. In the case of those affiliated with Northwest Growth Fund the payoff, so to speak, is still to be realized. When you hear their stories I know you will appreciate that we did not make these investments for the quick buck; but what I hope you will learn from them is that those of us in the SBIC program give a lot of ourselves as well as money in an attempt to achieve some success.

When the Government provides funding to a SBIC, that SBIC or MESBIC in turn invests not only the money but contributes a lot of time and effort counseling its client. The only way that we will be successful is if our small business clients are successful. Our rewards are not at his expense but they are a sharing of future value to which we have made a contribution of money and counseling.

Such an arrangement is unique to venture capitalists, I believe, among all the various financial sources available to businesses.

It is this aspect of our business that is least appreciated by our regulators at SBA. If it sounds as though I am suggesting that the SBIC is the major contributor to the partnership between the entrepreneur and ourselves, I want to be quick to dispel that notion.

The entrepreneur is the real hero in the play. Without what he gives of himself, his creativity and talent, his long hours of labor, his perception of his goals and amazing optimism in situations in which most of us would become totaly discouraged, the partnership would fail miserably.

These entrepreneurs represent the finest and purest expression of the American economic system and I am proud to be able to work with them.

We have here this morning one of my favorite entrepreneurs, Luther Prince.

[The Economic Survey of Northwest Growth Fund, Inc. follows:]

NORTHWEST GROWTH FUND, INC.

Economic Survey

The following economic survey was completed for small business companies in Northwest Growth Fund's portfolio as of December 31, 1981

		Fiscal Year Before Initial NWGF Financing*	First Fiscal Year Following Financing**	Total of Columns 1 and 2	Most Recent Fiscal Year
	Foreign	$ 3,713,357	$ 1,337,750	$ 5,051,107	$ 114,826,075
Sales:	Domestic	330,107,508	60,886,048	390,993,556	1,031,750,823
	Total	333,820,865	62,223,798	396,044,663	1,146,576,698
Gross Payroll		37,103,113	14,002,892	51,106,005	198,137,511
Federal Tax (Including Deferrals)		7,077,525	1,032,976	8,110,501	34,070,601
State and Local Income and Property Taxes (Including Deferrals)		309,445	156,836	466,281	5,502,552
Research and Development		3,028,767	509,362	3,538,129	55,311,603
Pre-Tax Profits (Loss)		8,431,500	1,657,577	10,089,077	65,551,807
Total Assets		160,550,849	50,317,558	210,868,407	887,958,633
Long-Term Debt		58,242,680	12,274,276	70,516,956	172,859,014
Net Worth		$ 59,998,683	$ 8,727,657	$ 68,726,340	$ 410,726,911
Full-Time Employment - Year End		3,338	1,103	4,441	13,348
Number of Companies		46	6	52	52

* Excluding Leveraged Buyouts

** Leveraged Buyouts Only

Mr. MITCHELL. Thank you very much. I have some questions. I would like to hear from Mr. Prince first and then have direct questions to both of you.

Thank you for being here. We do have a copy of your testimony.

TESTIMONY OF LUTHER T. PRINCE, JR., PRESIDENT, AULT, INC., MINNEAPOLIS, MINN.

Mr. PRINCE. Thank you, Mr. Chairman.

My name is Luther Prince, Jr., president of Ault, Inc., in Minneapolis, Minn.

Ault, Inc. is a small, minority-owned business located in Minneapolis, Minn. The company was originally incorporated in 1961 by Joseph Ault. I joined the company in 1962 as general manager. I was promoted to president in 1967, and my wife and I bought controlling interest in the company from Mr. Ault in early 1968.

When I first joined Ault, Inc. in 1962, it was a custom manufacturer of power supplies and magnetic components. It had 30 employees, sales of $500,000, and was enjoying profitable operations. However, it had only one customer. My first task was to broaden our customer base and lessen Ault's dependence on its one customer. This task proved to be a very difficult one because the company turned out to be noncompetitive and did not have the human and financial resources in place to develop the required level of competence to survive and grow. Within 2 years after this task was undertaken, Ault's major customer decided to set up its own division to manufacture those products that had been previously supplied solely by Ault. As can be expected, this created very serious survival problems for the company.

As Ault struggled to survive and find new customers, its internal financial resources as well as SBA guaranteed bank loans proved to be inadequate to sustain the company due to continuing losses. The resulting crises resulted in Mr. Ault's decision to sell the company in early 1968.

In mid-1968 I finally realized that our short-term survival depended on obtaining equity capital to augment the company's debt financing. It was during this time period that I began searching for sources of venture capital. With the help of a local businessman, I was introduced to a private venture capital company in Boston and an SBIC located in Minneapolis. By late summer these two companies agreed to provide Ault with $200,000 in long-term subordinated notes with warrants attached. This gave the company the support that it needed to continue in business. Both investment companies provided management assistance and the SBIC agreed to have one of its officers serve on Ault's board of directors.

Unfortunately, by the spring of 1969 it became apparent that the $200,000 capital provided by the previous investors was still insufficient to turn the company around. At that time the company's backlog was at an alltime high, however, working capital was severely depleted and the company was still unprofitable. After a careful examination of the company's condition and its potential, the two investors helped the company arrange an additional $300,000 capital infusion consisting of an additional SBA guaranteed loan of $150,000 and another $150,000 of subordinated debt with warrants attached. This enabled the company to capitalize on the opportunities that it had found, and the next 3 years found the company operating profitably.

By late 1973, however, it became apparent that newly evolving technologies and vertical integration by its customers would soon eliminate completely the market for Ault's products. The company and its board of directors were faced with the problem of redefining a new business strategy for the company, or watching it go out of business. The outgrowth of these deliberations was a decision to move the company to a completely new direction. During the period from 1974 to 1978, sales declined as the new thrust of the company was developing. Sales dropped from $3 million to $2 million and employment dropped from a high of 150 employees down to 60. By the end of fiscal year 1979, however, the new business strategy began to take hold and a period of successful growth has ensued ever since.

Today Ault, Inc. is engaged in the design, manufacture, and sale of its own proprietary line of electronic power conversion products to manufacturers of original equipment. Our major sales effort is directed toward the following industries: data communications, telecommunications, small computers, terminals and peripherals, security systems, and medical electronic systems.

To these industries, Ault, Inc. offers a standard line of power transformers, power supplies, and battery chargers for small systems where the overall power requirements are less than 25 watts. Ault's products are classified as external power converters and are packaged in esthetically attractive sealed plastic enclosures. They are designed either to be plugged into convenient electrical wall outlets or to be located adjacent to the system being powered. In contrast to internal power converters, products of the type produced by Ault, Inc. offer the following advantages: They eliminate hazardous voltage, the heat and magnetic interference from the end product enclosure thereby simplifying the physical design; they simplify the process or eliminate the need to UL list the end product which can reduce the time and cost required to obtain such product approvals.

Ault relies heavily on providing a service as well as a unique product to its customers. By primarily offering UL-listed standard products, the company relieves many of its customers of the burden, time, and expense of obtaining UL listing for their products. This service is especially important to the smaller company which does not have staff available and trained to deal with UL.

In fiscal year 1982, 4 years after our turnaround began, sales were in excess of $7 million and the company paid State and Federal income taxes of $20,000. This is the first time the company has paid income taxes in over 15 years, due to prior operating losses. By the end of the current year, sales are expected to exceed $13 million and the company expects to pay State and Federal income taxes in excess of $500,000. During the last 12 months—and we're especially proud of this—the number of employees has increased from 150 to 300, and we are confident that we can double our business every 3 years. Although the private venture capital company is no longer involved, the SBIC is still involved. This company has not only converted its subordinate debt into preferred stock, but also made an additional $100,000 loan to the company 3 years ago at a time when such a loan was badly needed. Without the financial and managerial assistance of this SBIC there is no doubt that Ault, Inc. could not have survived, and would have missed the opportunity to contribute to the revitalization of the U.S. economy.

[Mr. Prince's prepared statement follows:]

PREPARED STATEMENT OF LUTHER T. PRINCE, JR., PRESIDENT, AULT, INC., MINNEAPOLIS, MINN.

Ault, Inc. is a small, minority-owned business located in Minneapolis, Minnesota. The company was originally incorporated in 1961 by Mr. Joseph Ault. I joined the company in 1962 as general manager. I was promoted to president in 1967, and my wife and I bought controlling interest in the company from Mr. Ault in early 1968.

When I first joined Ault, Incorporated in 1962 it was a custom manufacturer of power supplies and magnetic components. It had 30 employees, sales of $500,000 and was enjoying profitable operations. However it had only one customer. My first task was to broaden our customer base and lessen Ault's dependence on its one customer. This task proved to be a very difficult one because the company turned out to be noncompetitive, and did not have the human and financial resources in place to develop the required level of competence to survive and grow. Within 2 years after this task was undertaken, Ault's major customer decided to set up its own division to manufacture those products that had been previously supplied solely by Ault.

As Ault struggled to survive and find new customers, its internal financial resources as well as SBA guaranteed bank loans proved to be inadequate to sustain the company due to continuing losses. The resulting crises resulted in Mr. Ault's decision to sell the company in early 1968.

In mid-1968, I finally realized that our short-term survival depended on obtaining equity capital to augment the company's debt financing. It was during this time period that I began searching for sources of venture capital. With the help of a local businessman I was introduced to a private venture capital company in Boston and a SBIC located in Minneapolis. By late summer these two companies agreed to provide Ault with $200,000 in long-term subordinated notes with warrants attached. This gave the company the support that it needed to continue in business. Both investment companies provided management assistance and the SBIC agreed to have one of its officers serve on Ault's board of directors.

Unfortunately, by the spring of 1969 it became apparent that the $200,000 capital provided by the previous investors was still insufficient to turn the company around. At that time the company's backlog was at an alltime high, however: Working capital was severely depleted, and the company was still unprofitable. After a careful examination of the company's condition and its potential, the two investors helped the company arrange an additional $300,000 of capital infusion consisting of an additional SBA guaranteed loan of $150,000 and another $150,000 of subordinated debt with warrants attached. This enabled the company to capitalize on the opportunities that it had found, and the next 3 years found the company operating profitably.

By late 1973, however, it became apparent that newly evolving technologies and vertical integration by its customers would soon eliminate completely the market for Ault's products. The company and its board of directors were faced with the problem of redefining a new business strategy for the company or watch it go out of business. The outgrowth of these deliberations was a decision to move the company in a completely new direction. During the period from 1974 to 1978 sales declined as the new thrust of the company was developing. Sales dropped from $3.3 million to $2.3 million and employment dropped from a high of 150 employees down to 60. By the end of fiscal year 1979, however, the new business strategy began to take hold and a period of successful growth has ensued ever since.

Today Ault, Inc. is engaged in the design, manufacture, and sale of its own proprietary line of electronic power conversion products to manufacturers of original equipment. Our major sales effort is directed towards the following industries: data communications; telecommunications; small computers, terminals and peripherals, security systems, and medical electronic systems.

To these industries, Ault, Inc. offers a standard line of power transformers, power supplies, and battery chargers for small systems where the overall power requirements are less than 25 watts. Ault's products are classified as external power converters and are packaged in esthetically attractive sealed plastic enclosures. They are designed either to be plugged into convenient electrical wall outlets or to be located adjacent to the system being powered. In contrast to internal power converters, products of the type produced by Ault Inc. offer the following advantages:

1. They eliminate hazardous voltages, heat and magnetic interference from the end product enclosure thereby simplifying the physical design.
2. They simplify the process or eliminate the need to UL list the end product which can reduce the time and cost required to obtain such product approvals.

Ault relies heavily on providing a service as well as a unique product to its customers. By primarily offering UL listed standard products, the company relieves many of its customers the burden, time, and expense of obtaining UL listing for their products. This serice is especially important to the smaller company that does not have staff available and trained to deal with UL.

In fiscal year 1982, 4 years after our turnaround began, sales were in excess of $7 million and the company paid State and Federal income taxes of $20,000. This is the first time the company has paid income taxes in over 15 years due to prior operating losses. By the end of the current year, sales are expected to exceed $13 million and the company expects to pay State and Federal income taxes in excess of $500,000. During the last 12 months—we are especially proud of this—the number of employees increased from 150 to 300 and we are confident that we can double our business every 3 years.

Although the private venture capital company is no longer involved, the SBIC is still involved. This company has not only converted its subordinate debt into preferred stock, but also made an additional $100,000 loan to the company 3 years ago at a time when such a loan was badly needed. Without the financial and managerial assistance of this SBIC there is no doubt that Ault, Inc. could not have survived, and would have missed the opportunity to contribute to the revitalization of the U.S. economy.

Mr. MITCHELL. Thank you, sir. That is really quite a story of struggle and a story of success. Certainly you are to be commended for your perseverance and sticktoitiveness and so is the SBIC.

Initially, you indicated that you haven't had all winners. You have had your share of losses. Is it possible for you to single out one, two, or three elements that contributed to the figure of that percentage of companies that did fail?

Mr. ZICARELLI. I think one that every investor immediately characterizes is inadequate management. That has certainly been the case in a number of situations which we were in. However, some of the fault lies in our company as well, in that many of these companies were in the development stage of products and we underestimated the degree of difficulty to bring those products to market. The cost of doing it just exceeded our capacity or our courage, so to speak, and we were unwilling to continue the financing.

There are often things beyond everybody's control, a recession that lasts too long, tight money when the banks refuse to continue to support a business, and just getting out of phase. We had one situation in which we lost a substantial amount of money where the company had a very attractive product. It began to make very substantial inroads in the marketplace. When it got the product out in the market, the product didn't work. They had to get it back in and do the fixing up. They lost their sales momentum and by the time they were ready to go back in the marketplace they didn't have a sales organization left. The market had turned sour and found other products to provide that need that they once had.

Mr. MITCHELL. You make frequent reference to the management counseling that you provide. In your case it is clear that someone went on the board of your company to help provide that kind of agreement counseling.

Mr. PRINCE. Yes.

Mr. **Mitchell**. But apart from that method, let me go back a little bit. I have always been very wary of and skeptical of references to management assistance because I have found that it varies from a one shot visit to a place to a series of intermittent visits on "How is everything going, Joe?" I would like to know a little bit more about the nature of the management counseling that you provide. Is that often requested by the recipient company or do you recommend it? How often is that kind of assistance provided and on what sort of basis?

Mr. **Zicarelli**. That is a good question, Mr. Chairman.

The type of counsel that we provide is generally business counsel. It is an oversight type thing. We don't attempt to get in and try to operate a business. I couldn't operate a business of any kind and I admire people who can. What we can provide is the fact that we have an exposure to 50 or 60 other companies and the experience that they have had in trying to react to certain types of problems and to their needs for financing, some of their marketing strategies or operating problems. What we tend to do if we know that our small business client is having a problem of some kind is to make a reference to somebody in one of our other portfolio companies who has experienced a similar problem and might be able to help him or to pass on some advice ourselves with regard to that problem.

Mr. **Prince**. Bob, could I speak to that particular point?

Mr. **Zicarelli**. Sure.

Mr. **Prince**. I would like to cite an example in our particular relationship. Incidentally, Bob is the gentleman who is on my board.

Mr. **Mitchell**. I assumed that.

Mr. **Prince**. During one of the many, many times when we were faced with crises, one of the things that has kind of carried me through in most instances has been my optimism that things were going to get better, but there are times when even I couldn't retain optimism in the face of some things that were going on.

I would like to mention something that is kind of intangible in a way. I remember one time having a discussion with Bob and another one of our investors. At the time I was totally depressed and I had just about gotten to the place that I had lost faith in the company myself and I didn't think the company could survive. I recall asking Bob had he run across other entrepreneurs who were in the same mental state of mind that I was at the time and what had they done about it to pull themselves out of this condition. My recollection, and I don't know if you remember the conversation, Bob. He said well, yes, we have seen other people who have been in the same boat you are in and usually this happens when a company doesn't have a clear focus on where it wants to go. If you are kind of confused and looking in 80 different directions and trying to find a path to follow, this does cause depression. So I had said my advice to you is if you can find a direction you want to go and clearly think it through, that even though things are still bad, you will get out of that state of depression and you will be able to function effectively and that is exactly what happened. I don't know if you call that management assistance, but there was a case where it certainly helped.

Mr. MITCHELL. That was moral assistance, not management assistance.

Mr. ZICARELLI. Luther just isn't an isolated incident of that. I have had a number of other companies that faced problems. I remember a company down in Phoenix that had been struggling for years and had been facing a lawsuit which had been holding back its sales. I got down there and this fellow was just ready to throw in the towel and we had to give him a little peptalk and try to encourage him that somebody else had some confidence in what he was doing and that the opportunities that we started out to bid on were still there and we wanted to see him reach his goals and we gave him some moral and financial support and got him turned around and it became a very successful investment for us.

Mr. MITCHELL. I have just two other questions and then I will go to Congressman Siljander. I have two questions and one kind of aside. You got started in 1967 or 1968?

Mr. PRINCE. I took over the company in 1968 from the ownership point of view.

Mr. MITCHELL. Finally, this year you are doing very, very well and you expect to do better in the future. I think the Small Business Administration has embarked on an absolutely ridiculous policy of fixed program participation terms for minority small business. You can be in the program only up to 5 years or with a 2 year extension. It has been my experience that it takes almost 20 years for any small business to really become successful, or viable in the sense that it is secure enough that it can go public and sell stock.

I just think that is a very foolish new policy that has been instituted by the Small Business Administration. You can't make a business successful, necessarily, in 5 years. Some businesses may be, but the general rule of thumb is no.

Now, we have to deal with the one unpleasant portion—the highly publicized article that was spread around the corridors of Capitol Hill about SBIC's making loans to well-heeled people, Charlton Heston and some others. I don't recall their names. The fact that one of the members of this committee when he heard about the article said I wished I had known that before. I just voted to continue SBIC's.

How do you respond to that? Are you familiar with the article that I am talking about?

Mr. ZICARELLI. Yes, I am.

Mr. MITCHELL. I am sure most people are. How do you respond to that? How do you justify making "loans" to various entities which might well have gone to the regular institutions to secure money?

Mr. ZICARELLI. I think that the statistic that you and I both quoted earlier—that we made 66,000 loans or investments primarily over this period of time is one that—one can pick out of that various objectives to suit one's own purpose. The persons that we back, we are backing with equity-type funds. The fact that the management or the investors that we are backing have resources of their own, really, I don't think is that pertinent. The question is whether the business that we are investing in is a viable business, has potential, is operating ethically, and contributing something to society. Whether Charlton Heston or J. D. Rockefeller wants to start that business, we are still looking at the fundamentals of that business and have to see it through.

Mr. Mitchell. May I interrupt you for just a moment?

Mr. Zicarelli. Sure.

Mr. Mitchell. I think the problem that occurs is that in the minds of people when you talk about movie stars and other easily identifiable public figures, the automatic assumption is that these folks are already wealthy. Therefore, their businesses are really not small businesses in any sense of the word and, therefore, ipso facto you should not be investing in them. Now, having posed that question, were all of these ventures legitimate small businesses in your estimation?

Mr. Zicarelli. Well, the fact that a person who has many millions of dollars behind a business doesn't necessarily determine whether the business itself qualifies as a small business. Yes; I believe they were qualified businesses. I certainly would question the one illustration I can remember of somebody financing some porn shops in New York, but to finance a business of any type that is legitimate and ethical and has potential to it no matter who is behind it doesn't seem to me to be something that we should be restricted from doing.

Mr. Mitchell. Then you are satisfied that in general, all of these companies are small businesses?

Mr. Zicarelli. Well, I think, Mr. Chairman, that there probably are violations in the program of people who have financed companies that weren't intended by the regulations, but I think they are very miniscule. I don't think that they are hurting or jeopardizing anybody or depriving anybody within the program who has legitimate needs from getting funds from other sources.

Mr. Mitchell. Even the awful illustration of the so-called porn shops in New York has got to be weighed against the enormously successful record that you have made. You wanted to make a comment?

Mr. McNeish. If nothing else, Mr. Chairman, just to clarify the point that it wasn't Charlton Heston, it was Paul Newman.

Mr. Mitchell. Paul Newman, I am sorry. The last movie I saw was the original version of "Gone With the Wind," so you can understand why I am confused.

Mr. McNeish. I am with you, Mr. Chairman.

Second, the article was quite misleading because Paul Newman was not a principal in a small business being financed. Paul Newman and other persons from the movie industry had, in fact, invested funds in a SBIC. The article was misleading when it suggested Paul Newman was receiving subsidized funds from the Government. In fact, he was not. The SBIC was drawing down leverage, but the point of fact is that Paul Newman and the other individuals were utilizing the SBIC in a positive sense to put their money into small business investments. I would much rather have those dollars from those sources invested in small business than unproductive tax shelters elsewhere.

Mr. Mitchell. My last question, I think you have indicated that if we maintain a funding level of $160 million for next year, means that roughly no growth. Is that right?

Mr. **Zicarelli**. Yes, that is right. There is something like $155 million of debt coming due this next fiscal year. The $160 million, therefore, could really provide no new money if most of that money is required to keep companies in the program. It is just clear to me that the SBIC industry, if it is investing at a $350 million a year rate is just going to need additional capital to continue investing at that rate. It seems to me a very desirable thing for the economy at this point to have small business investment companies providing the stimulation necessary to grow new businesses.

Mr. **Mitchell**. Well, I can certainly assure you that some of us are going to work very hard and stick to a minimum $250 million level. It just makes good sense to do that. While we are cutting budgets, it would be foolish to make cuts which effectively will deny revenues coming into Government. That just doesn't make sense.

Congressman Siljander?

Mr. **Siljander**. There is $155 million thus far invested. Do you feel that the money will be rolled over again or would part of that be rolled over and part be paid off. What do you envision happening with the $155 million?

Mr. **Zicarelli**. I understand SBA did a survey of the SBIC's and the indication was that about $90 million of it would probably be rolled over. I don't know if the issue you may be raising is, should it be rolled over. One of the problems of our kind of business that makes rollover something that has to be addressed is, when we invest in companies such as Ault and that investment goes over 13 years or more—and we are 13 years now—we are not likely to get out in the next year or so. We have a real liquidity problem. So unless SBA works with us and agrees to help us by rolling over the funds that we have already committed to small business, we could be in serious straits.

I think SBA today is making credit judgments about companies which are facing that problem: Their debt is coming due, and SBA is deciding that the credit situation may not justify continuing to roll over that money. I am not going to argue with their credit appraisals, but it seems to me that if you had a policy of rolling over, you can't change it when the money comes due. There is no way that those companies can become liquid enough to repay the money in a short period of time with the long-term investments that they are making. I am not sure that it serves the best interest to go to portfolio companies like Ault, and force them to repay us so that we can repay SBA.

The other side of the coin is that we are supposed to make some profits by investing that money, and be able to pay it off. Typically, what we are doing with the profits is really investing it in some new worthwhile businesses so we continue in our illiquid mode and that is part of the problem, too. If SBA wants to have us repay it, they should enunciate a more clear policy on what they want done with the debt as it becomes due.

Mr. **Siljander**. Mr. Prince, you were brought in as the optimal example of success, a company coming from doom and gloom, or at least perceived to be doom and gloom, to success. I guess I am encouraged by the fact that Mr. Zicarelli came to you and gave you a pep talk and he stuck with you. But in a more tangible way, can you tell us how specifically their sticktoitiveness helped you pull through or focus your interest into a higher technology area to become successful from 150 employes down to 60 up to 300; that is a tremendous increase. I think your brilliance and/or the sticktoitiveness of the SBIC is something that I am very interested in. I think it is a marvelous example of the private sector entrepreneurship, but I guess besides all the niceties, I would like to know the specifics without going into great detail—the five, three, four points of how they really helped you in a tangible sense.

Mr. **Prince**. Let me give you an example or two in the financial area. For a company to have losses for 15 years and stay in business means that there had to be money coming from somewhere, just the intravenous feeding to keep the patient alive. So, during this period, I would have to say that we have had to raise capital of over $1 million. A lot of it was debt. But I think if you have had any dealings with bankers, you can appreciate that after a short romance period, banks are pretty quick to give up on you. And even the SBA.

I have been turned down at a time when I desperately needed money just to keep the doors open by both the banks and by the SBA. The only person that was able to bail us out of the situation were the venture capitalists by going to the banks and literally twisting their arms to get them to reconsider.

This happened more than once when we had just gotten notice from the bank and notice from the SBA. We would go back and regroup, and then Bob and the other venture capitalists would go to the banks. Generally, what is required is if you have so much faith in this company, why don't you put some more money into it, rather than having the banks do it? So, what has generally happened is each time the banks and the SBA agreed to put more money into it, they had to do something else, and one of the last things is we have to recapitalize the company two or three times. One of the things they did, for example, was to convert their debt into an equity position to clean up the balance sheets so that when the SBA and the bank did their analysis, they looked at these ratios and so forth, and saw more had been converted to equity.

I don't want to get into a lot of detail, but on four or five occasions it was because of their insistence the bank and the SBA agreed to come in for this additional financing. So that would be one area. Without that, we just couldn't have made it.

Mr. **Siljander**. Financial?

Mr. **Prince**. That is one. I can go on, as I mentioned, in the managerial area if you would like me to. I don't know how much time you want me to spend on that. If you want me to go into specifics I can, but I can just say this: One of the most valuable assets of Ault Inc., is its board of directors. Bob has been on the board. It is a very active board.

In troubled times, we met once a month. In less troubled times, we meet every other month, and we have committees which work, so that all of our directors have taken an active role.

There were times when I was the only person in the management of the company. I didn't have anybody else because I had to let them all go just to survive. So it was during that time to our directors and the particular investors provided that type of dialog which I had to have somebody to talk to.

When things get so down and you can't walk around the plant looking gloomy because that scares everybody else, but you have to have someone to go talk to and devise strategies and that way, they have been very helpful.

Mr. **Siljander**. Besides your analysts, has he also been of financial assistance to you and a director of business management with a new vision for you in entrepreneurship?

Mr. **Prince**. Absolutely, and I might add that neither the bank nor the SBA are inclined to provide that kind of help. I have never gotten any positive help from them.

I might cite one example, just show you how some of the people are. My loan officer at the SBA, a guy who had been handling my account for a period of time, became ill and he was taken off the case, but he happened to come back in the office one day when I was in there applying for a desperately needed loan, and he looked at me and he said, "If I were here, I would see that you didn't get that loan."

Mr. **Siljander**. He said what?

Mr. **Prince**. He would see that I did not get the loan, and he was telling me this because he meant well for me. He said, "Lou, you are trying to grow too fast and if you get this loan, you are going to overextend yourself, and therefore, I don't think you should have it, but I am not here." Fortunately for me he was not there.

Mr. **Mitchell**. You got the loan?

Mr. **Prince**. I got the loan. He meant well in his own different mindset.

Mr. **Siljander**. You have given me three points and that is what I requested, and I thank all three of you for your testimony.

Mr. **Mitchell**. Certainly, I do also. Thank you very, very much. I don't have any additional questions.

Mr. **Mitchell**. I have the next panel now consisting of E. Patric Jones, from the Urban Fund of Illinois; Jack Thompson of Opportunity Capital Corp. of California, and John C. Lee, president of Equitable Capital Corp. of San Francisco.

If those witnesses would come to the table, please, we will start taking your testimony.

Ordinarily, I let the witnesses determine for themselves who wants to go first, but as I understand you, Mr. Jones, have to catch a plane to Chicago, so for that reason, with the consent of the other witnesses, could we at least get his testimony in first?

I think we will be finished with you in plenty of time to make your plane, but I really would like to get your testimony in first, if that is acceptable to you gentlemen.

Mr. Jones?

PANEL CONSISTING OF E. PATRIC JONES; PETER THOMPSON; AND JOHN C. LEE

TESTIMONY OF E. PATRIC JONES, PRESIDENT, THE URBAN FUND OF ILLINOIS, CHICAGO, ILL., AND CHAIRMAN, AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY DIANE THOMAS, AAMESBIC, WASHINGTON, D.C., AND JOHN LOPEZ, PRESIDENT OF A MC DONALD'S FRANCHISE

Mr. Jones. Good morning, Mr. Chairman and members of the committee. I am E. Patric Jones, president of the Urban Fund of Illinois, located in Chicago, and as of October, chairman of the American Association of Minority Enterprise Small Business Investment Companies, also known as AAMESBIC.

AAMESBIC represents over 125 MESBIC's across the country. Testifying today with me are AAMESBIC members Peter Thompson, president of Opportunity Capital Corp. here in San Francisco, and John Lee, president of Equitable Capital Corp., also here in San Francisco. In addition, we will be accompanied by John Douglas of National Group Television and John Lopez, president of a McDonald's franchise who are representing the hundreds of small business concerns that have received MESBIC assistance.

I would like to begin by telling you a little about the Urban Fund of Illinois, which was incorporated in March 1971. We are owned by Hyde Park Bank and Trust Co., First National Bank of Highland Park, and Marina Bank. While we concentrate our investment activity in the Illinois-Indiana-Wisconsin region, we do have investments in New Jersey and in your State of Maryland.

The Urban Fund of Illinois has completed 37 financings to date, totaling approximately $3.5 million. Our MESBIC dollars have been the equity base for some $26.4 million in total financings of minority businesses. This includes banks and other MESBIC's. Many of our investments involve fast food franchises. The Urban Fund was in fact the catalyst in developing the largest fast food franchise in the country, a chain of 17 Burger Kings.

Our portfolio includes 10 McDonald's, and the Chicken George chicken chain in Baltimore, Md. Our concentration in fast-food franchises is based not only on the potential profitability of the industry, but also on our belief that a good franchise system represents a workable solution to the management problem facing inexperienced and untried minority entrepreneurs. With an established franchise system, a franchise simply has to follow operating manuals provided by the franchiser, and to follow the system.

Importantly, fast-food franchises create jobs especially for urban teenagers. We do however invest in other areas, including manufacturing companies like a $10 million paper distributor and a cable TV franchise. Through much luck and hard work, our MESBIC has managed to consistently generate profits.

We are somewhat unique in that we manage another MESBIC, Combined Opportunities, Inc., a wholly owned subsidiary of Combined Insurance Co. of America. I am also an officer of this MESBIC. Since 1971, our investment dollars have maintained or created approximately 3,200 jobs, most of which have been in the inner city. Our current portfolio of 13 businesses have combined sales of $30.5 million and employ approximately 1,300 people.

MESBIC's, also known as 301(d) SBIC's, are authorized under the Small Business Investment Act of 1958, as amended, to provide venture capital to minority entrepreneurs. MESBIC's do this through a unique public/private sector partnership which utilizes a base of long-term private capital which can be leveraged to additional SBA dollars. This greatly increases the pool of capital available to minority-owned businesses.

In 1981 alone, MESBIC's invested over $54 million in minority businesses. These investments helped to create or maintain more than 12,000 jobs in the sector of the population which is currently experiencing over 20-percent unemployment. Assuming an approximate 1-to-1 ratio of Government to private dollars invested, each job cost the Government approximately $2,250. This does not include the benefits accruing to the Government from these investments, such as payroll and corporate income taxes generated by these investments. We think these payments to the Government in 1981 were approximately $36 million.

Clearly, the MESBIC program is now effective and efficient. As in any program, private or public, there are inevitable problems, but our track record says that we are attaining those goals that were outlined as the intent of the law. Today's hearings come at a very crucial time for the MESBIC industry. In August of this year, the Small Business Administration introduced a proposed new set of regulations for the small business investment company industry that I firmly believe is contradictory to the intent of the Small Business Investment Act.

Frankly, Mr. Chairman, I believe these proposed regulations, if enacted, will cause the demise of the MESBIC industry as we know it. These proposals are a result of what the industry has viewed as a deleterious change in the attitude that the SBA has adopted toward SBIC's in the past few years. SBA appears to have lost sight of the fact that MESBIC's are private companies. As such, should a loss be sustained, it is the private capital that goes first. MESBIC executives absolutely must be free to make the management decisions vital to MESBIC profitability, and thus indirectly vital to the very continuation of the industry.

Financial analysis, risk evaluation, and investment decisions cannot be legislated. The SBA has begun to structure its policy on SBIC's to address the more political aspects of the program, to the inescapable detriment of the financial aspects of the program. This change in focus poses a very serious threat to the future of the industry. The fundamental philosophy of the MESBIC program was that of a partnership. Government would induce the private sector to do what Government had been unable to do, that is to provide a continuing source of capital to minority businesses efficiently, and in a way which that contributes to the overall economy.

By its nature, the program provided a profit incentive to the private sector. It was never intended to be a giveaway or grant program. MESBIC's are businesses, or for-profit corporations. These proposed regulations greatly reduce the ability of MESBIC management to make its own decisions; and they significantly reduce any potential profit incentive. These regulations will surely strangle the very industry they are purportedly designed to help.

Let me be more specific: Significant among these changes is the proposal regarding redemption rights on equity securities, options, or warrants. AAMESBIC believes that SBA's intention with respect to this proposal's implementation is good. SBA obviously wants to see small business concerns get a good deal. It is truly unfortunate that small business concerns must pay such high yields to attract equity type capital from SBIC's and MESBIC's.

However, SBIC's must pay the SBA, in turn, high interest rates on borrowed funds. The problem, then, becomes how to pass along low-cost funds to our investees at a rate that is lower than the combined interest charges of SBA, our cost of doing business and the recovery of investment losses. Most importantly, let's not forget: This is extremely high-risk money. If it weren't, the small businesses could get conventional bank financing.

It is obvious that SBA has, in the promulgation of this proposed rule, ignored the means by which SBIC's structure investments to achieve their desired return on investment. The structure is generally comprised of one or more parts, a split between a yield on an interest bearing security and/or an equity interest evidenced by stock, warrants, and/or options to purchase stock.

The proposed changes would limit both the interest yield on the related debt securities and the put price on the warrants, stock, or options held. The put price is the price at which the small business can buy back our interests.

The SBIC still has to find a means to achieve its desired minimum return on its investment. Under the proposed changes, we will have two alternatives: One, refuse to structure a put and/or call into the financing, and simply plan to sell the small business concern's stock to a third party at some future date; two, elect to take more equity rights, thereby acquiring a greater share of the small business' equity than we would otherwise have to, were the SBIC allowed to sell its shares back to the investee at the end of the 7-year holding period at a negotiated price.

SBA will get its interest on its debentures, and its principal repaid. The MESBIC gets its gain which allows it to cover losses and operating expenses, pay SBA, and earn its industrywide annual net profit after taxes of 1 percent, which by SBA's definition is excessive, as shown by its statements that SBIC interest rates charged to small concerns are excessive.

To the small business concern, the cost of the restructured financing could be absolutely devastating. Imagine such a concern, if financed by an SBIC, having its loan mature in the seventh year after closing.

That maturity incidentally could be in the form of a balloon because of the new SBA regulations requiring extended amortization and maturity periods for such financings.

In addition to the repayment of the loan, the small concern will also have to payoff a put, that is buy back stock—involving more shares than would otherwise have to be repurchased if the old regulations governed the structure of this financing. If the SBIC elects not to structure a put or a call on its equity, then to achieve its gain the SBIC may decide to sell its equity rights to a third party, preventing the small business concern from recovering its equity on any reasonable basis. Somebody else then will own part of his business.

The proposed changes in the cost of money for loans and debt financings are of major concern. AAMESBIC believes SBA has ignored the existence and use of a formal pricing mechanism among most SBIC's which balances the risk of investment loss against an investment yield. Clearly, SBA has completely ignored the fact that SBIC's make investments in extremely high-risk ventures. Some of these ventures will hopefully be successful. However, many others will go out of business and the SBIC will lose its entire investment even though SBA's leverage dollars are fairly secured.

MESBIC's by their very nature are hybrid venture capital firms. Few if any pure venture capital firms operate with debt. Most are prepared to suffer a 100 percent loss. They have tremendously larger capital bases. Therefore, they take greater risks than MESBIC's.

MESBIC's are highly leveraged and are obligated to repay SBA 100 percent of its leverage funds. Therefore, we cannot invest as pure venture capitalists invest. SBA surely must realize this difference; yet, SBA is regulating a required risk exposure which is inconsistent with the capital structure of the MESBIC industry, which is highly leveraged with debt.

AAMESBIC believes that this proposed change, combined with others, will drastically weaken the SBIC program and cause the unwarranted loss of tens of millions of dollars of private investors' funds. Clearly, the aggregate net income figures of the SBIC's and especially the 301(d) SBIC's do not support the SBA's contention that excessive yields are being extracted from small business concerns.

AAMESBIC has respectfully asked the SBA to analyze the potential impact of these regulations more carefully. It is important that a proper balance be maintained between the investment risk and yield so a SBIC can remain solvent and continue to provide capital to minority businesses.

The proposed regulatory change reducing the impairment ratio to 75 percent from 100 percent, combined with other proposed regulations, will create a difficult operating environment for MESBIC's in an already tumultuous economy. At a time when America is experiencing the highest level of bankruptcy among small and minority businesses, and depression levels of unemployment among minority persons, the SBA has set in motion a proposed regulatory change which will place an undue strain on many already harrassed minority concerns.

Some 301(d) SBIC's that are near the new proposed impairment ratio, if it becomes a regulation, will have to commence foreclosure proceedings against these same minority concerns to protect themselves from their own liquidation by the SBA. We believe that such an action can only lead to the future unemployment of thousands of minority workers employed by these concerns. Last year alone, MESBIC investments helped to create or maintain close to 12,000 jobs.

AAMESBIC believes that SBA's proposed regulatory requirement that financing for small business concerns be extended from 30 months to 5 years is well intended. However, the SBA seems to have ignored the practical reality of 301(d) financings.

Because SBA charges all 301(d) SBIC's for their funds, the 301(d) SBIC's must charge all small businesses for the funds that they invest. It is reasonable to assume that if SBA mandates a certain percentage of 301(d) funds be invested at high risk on a subordinated and unsecured basis for a longer period of time at a lower yield, the losses of the 301(d) SBIC's will increase.

To illustrate, if $100,000 is invested for 30 months at an interest yield of 12 percent, and a presumed yield on warrants of 8 percent, the required net cash payments to the MESBIC will be $164,000. However, if the same amount is invested for 5 years, or twice as long, the cash payment will be $269,597, or a $104,000 increase in the required total of the funds to be repaid to maintain the MESBIC's 20-percent return on investment.

The net effect of the regulatory change is that more money will be paid out by the small businesses without any corresponding benefit having been gained. MESBIC managers are well aware of the cash flow problems of their investees and, when required, flexible repayment arrangements are always negotiated. Moreover, we believe that the regulations take away the flexibility to adjust financing terms and to lend funds for the period of time assessed as being most appropriate for the individual small business. The proposed extended maturity period on certain investments will decrease the liquidity of MESBIC's over time, and thereby reduce the volume of future loans and the number of disadvantaged concerns which could otherwise be helped. In addition, lengthened maturities will increase the cash burden to be paid by disadvantaged concerns because of the potentially higher cost of longer term funds.

Historically, the regulations have provided the SBIC's the right to rebut any contention on the part of the SBA that the SBIC has been inactive. SBA has always retained the right to reject the rebuttal as being inconsistent with the intent of the legislation, and hence has always had the right to cite the SBIC as being in violation of the regulations if it so deemed.

However, SBA now presumes to establish a specific standard such that an SBIC will no longer, under any set of circumstances, be able to rebut a contention that it is in fact inactive. SBA would suggest that any SBIC which has, at the end of the fiscal year, approximately 25 percent of its assets in idle funds and has not financed during the prior 18-month period small business concerns with funds approximately 20 percent of the idle funds, is in fact inactive.

SBA fails to take into consideration that the idle funds themselves comprise many different capital components. For instance, SBA does not presume to take into consideration commitments which the SBIC may have made which can be significant. The SBA does not presume to take into consideration current liabilities of the SBIC which would normally be paid out of idle funds. SBA further does not take into consideration that an SBIC may, in fact, be accumulating cash to retire obligations of the SBA.

In the past few months, it has been made clear to the industry that the rollover of the debentures held by a SBIC is not an automatic occurrence. SBA has told many SBIC's that they will not allow them to roll over their debentures, thereby creating fear among the SBIC's that the SBA on an ad hoc basis makes a decision whether or not to continue the financing of a SBIC.

It is without doubt ironic that at the same time the SBA has been withholding rollover privileges from the SBIC's, it would also put into place a standard which would make the accumulations of cash to retire such debentures a prima facie event of default under the new regulations. In short, we are damned if we do, and damned if we don't. AAMESBIC strongly objects to the implementation of this new standard and suggests that the SBA leave in place the existing regulation covering inactivity as it relates to operating SBIC's.

Finally, I would like to comment on a matter that your committee affects directly. Each year, the level of leverage dollars available to the MESBIC industry is determined by the budgetary process. Each year, the industry is faced with the prospect of possible cuts in a program that has proven itself time and time again before your committee. You have always been a friend to us, Mr. Chairman, and I want you to know how much we appreciate that. I want to take this opportunity, however, to stress just how important it is that the program be maintained on a consistent level.

Operating in an unusually uncertain business climate makes the knowledge of the future availability of capital even more important to our investors. Stagnant or decreasing appropriation levels for a program making increasingly larger investments in a growing number of firms threatens the viability of the entire program. Therefore, we ask once again for your committee's support in the budgetary process.

In summary, AAMESBIC believes that the implementation of the SBA's proposed regulations will be detrimental to all SBIC's, but to the 301(d) SBIC's it will be disastrous. It will harm small businesses and will ultimately result in the insolvency of the MESBIC program. Clearly, SBA, through its regulations, is putting at risk approximately $110 million of private investors funds now invested in 301(d) SBIC's. These funds were raised by 301(d) SBIC's based upon the set of regulations which now exists and the investors' feelings that they could operate within those regulations.

The changes proposed by the new regulations create a totally new environment that the investors will have had no part in creating. SBA cannot expropriate the capital of the SBIC's and 301(d) SBIC's for its own interest without giving in return some reciprocal benefits.

I suppose my personal experience might emphasize the pending disaster. When the proposals were first released, the Urban Fund's board of directors called them ludicrous. I was then directed to evaluate the effect of these proposals on our operations. I have little doubt, sir, that if the SBA enacts these regulations, my stockholders, comprised of three banks, will instruct me to liquidate. The Urban Fund will cease doing business.

Thank you very much, Mr. Chairman, for the opportunity to speak before your committee today. I will be happy to answer any questions you might have.

Mr. MITCHELL. I did want to put all the questions following all the testimony. When were they proposed?

Ms. **Thomas**. August 16 is when they were published.

Mr. **Mitchell**. How much comment time?

Ms. **Thomas**. A 90-day comment time.

Mr. **Mitchell**. Is there any feeling that some changes can be affected in these proposed regulations?

Mr. **Jones**. Since our convention, Mr. Chairman, there has been some indication from the SBA, primarily delivered, I think, at the MESBIC convention, that is some few of the regulations, there may be some compromise. I think our staff in Washington has also had a meeting with the SBA and they have indicated that there is room to compromise.

Dianne Thomas can comment on that, but I must say that our attitude is such that we appreciate and are encouraged by the indications of compromise, but based on history, we sort of take the approach that until it is in writing, until we actually have the changes, we won't relax our efforts.

Mr. **Mitchell**. I have some reluctance about interjecting the committee into this at this time, but I do wish that you would keep Major Clark, my contact person on the House Small Business Committee, abreast of the possibilities of compromise, that hopefully will be agreed to.

Congressman Siljander, you wanted to get in on this.

Mr. **Siljander**. Well, I don't want to get in too heavily with this, but I understand that when we were in San Diego on our hearing, there was a convention going on, and the Director of the SBA had indicated that he is more than willing to compromise on several of the proposed regulations that were suggested in August that you are very concerned about. Mr. Chairman, I believe you have called it ludicrous.

Mr. **Mitchell**. No. I said I was not, because I didn't want to be redundant.

Mr. **Siljander**. All right, whatever that means. But I can appreciate your concern to some degree about having it in writing before you believe it. But I would hope that if the Director of the SBA has made certain statements that seem, at least from my understanding, fairly clear that he intends to revise to some degree some of these regulations that we can have some faith in it. If there is no faith in the SBA at all, then maybe, Mr. Chairman, we need to have hearings with some other emphasis later on in the future.

Wouldn't you agree?

Mr. **Mitchell**. I would agree with you on that. Although I don't think that the witnesses today are suggesting that they have lost faith in SBA. This one particular witness is expressing his concern about the uncertainty what the bottom line will be on these proposed regulations.

Mr. **Jones**. Exactly, sir. I would like to comment that by no means is it an indication that we have lost the faith in the SBA. But you know, we have about 10 years of negotiating agreements and contracts and we take the approach that while an indication of willingness to compromise is very encouraging, there is a whole lot of room between where we are now, where the proposed regulations were in between, and until we know what the compromise is going to be, until we have sat in on those negotiations and discussions, we need all the assistance that we can get.

Mr. **Mitchell.** Gentlemen, thank you for going along with us. We will be glad to take your testimony, and I will not at all determine who the next witness will be. You make that determination.

TESTIMONY OF PETER THOMPSON, PRESIDENT, OPPORTUNITY CAPITAL CORP., SAN FRANCISCO, CALIF., AND BOARD MEMBER, AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT CO.

Mr. **Thompson.** We will do it in order.

Good afternoon, Chairman Mitchell and members of the committee. My name is Peter Thompson. I am president of Opportunity Capital Corp., located here in San Francisco. I am also on the board of the American Association of MESBIC's.

Opportunity Capital Corp. began operation in 1971. Its shareholders include Standard Oil Co. of California, Bank of America, Wells Fargo Bank, Hewlett Packard, Levi Straus, Bechtel Power Co., TransAmerica, Fireman's Fund, and many other prominent bay area businesses. Our MESBIC has a total of 65 investors.

Our investment philosophy might best be described as prudently aggressive. We currently have 15 companies in our portfolio, and over the years we have provided financing of approximately $3.7 million to 34 companies. We have invested in many industries including oil and gas exploration, metal fabrication, data processing and software services, savings and loan, cable television, radio and television broadcasting, furniture manufacturing, banking, real estate development, and others.

One of our local investments is television station KSTS in San Jose. There are not more than half a dozen minority-owned TV stations in the entire country. When Opportunity Capital and three other MESBIC's invested in KSTS, it was just a concept and a set of plans.

KSTS is an exciting, demanding deal. KSTS is the kind of deal that provides access to the upside potential that we all like to see. KSTS developed a format consisting primarily of financial news. San Francisco is a major financial center. San Jose is a rapidly growing city, and Silicon Valley is populated by people with keen interest in national business affairs. A financial news format seemed to be a good way to set KSTS apart from the competition.

Another of our portfolio companies is Golden Oak, a furniture manufacturing company we financed in 1972 along with several other MESBIC's. Golden Oak builds high-quality wood office furniture for major banks, S&L's, law firms, Fortune 500 companies, and others. Golden Oak manufactures and distributes an upscale line of executive furniture which includes desks, credenzas, bookcases, and seating.

My purpose for giving these examples is to illustrate the diversity of investment situations MESBIC's are involved with. Because of our diverse investments, and particularly because of the unique problems many minority entrepreneurs are faced with, it is especially important that MESBIC's have a certain degree of freedom in structuring their deals. I believe this necessity was recognized when the MESBIC program was legislatively mandated in 1972, and in the original regulations governing the program. Only through our present freedom have we been able to nurture the industry to a point where MESBIC's can be profitable and effective vehicles for assisting the minority small business community.

The Small Business Administration, however, has proposed a new set of regulations that threatens to destroy our ability to structure workable financings, and in essence our ability to achieve the purposes the program was intended to achieve. The regulations in proposed form would radically alter the way MESBIC's conduct business. The distressing thing is that in an era when the Government publicly proclaims to favor deregulation, it is doing just the opposite with the MESBIC industry. It really is making an unnecessary intrusion into the day-to-day operations of MESBIC's.

In particular, we are opposed to the "inactivity" as an automatic violation rather than a rebuttable presumption. Opportunity Capital Corp. increased its private capital base by more than $1 million in March 1981.

Should we repeat this performance in March 1983, it is possible that we may be in automatic violation of the proposed "inactivity" regulations.

Further, under another of SBA's proposed rules, SBA would have the option to put preferred stock back to OCC in the event of any violation of the regulations, however temporary, minor or technical. The result is that OCC would find itself in the ironic position of being severely penalized for increasing the private sector's participation in the MESBIC program.

Success in obtaining additional private capital will enhance the safety and security of SBA's position as a creditor and preferred stockholder of OCC. Why should we be penalized for this success?

In addition, we are opposed to SBA's proposal to deny leverage on Federal funds invested in MESBIC's. The association has brought this matter to the attention of your committee twice in the past year, so I will not go into the history of this problem here.

I would like to point out, however, that it was with the full knowledge and consent of SBA that the Department of Transportation purchased Opportunity Capital's preferred stock in 1979 with the expectation that matching leverage financing would be available from SBA. We feel that public funds invested in MESBIC's prior to the Comptroller General's July 29, 1980, decision should be eligible for leveraging.

The SBA has also proposed that debt securities be subordinated to substantially all borrowings of the small business concern. There are instances in which MESBIC subordination may not be in the best interest of the small business concern, the MESBIC, or the SBA, our creditor and shareholder. Moreover, in practice, debt security investments have functioned as quasi-equity in that the interest rates are typically below market rates, the securities are often subordinated to institutional debt so as to encourage financial institutions to participate in the financing of minority-owned businesses, the moratorium on principal payments is often liberal, and the principal repayment schedule is often graduated as opposed to level amortization as required by standard bank loan terms.

We are also concerned over SBA's proposal to change the minimum maturity and extend the nonamortization period. Negotiations between OCC and small business concerns always take into account the needs of the small business concern and the needs of OCC. Although the negotiations are influenced by OCC's anticipated needs for cash to meet ongoing overhead expenses, debt service obligations, and to provide cash for new investments, the final terms with respect to maturity and principal moratorium typically favor the small business concern.

In summary, I would like to state my belief that the proposed regulations run counter to the intent of the legislation that created the SBIC program. In my 11 years of experience in managing a MESBIC, the investment philosophy I have advocated for Opportunity Capital Corp. has matured and become increasingly sophisticated. My experience in negotiating deals that have proven beneficial to the minority small business community, Opportunity Capital, and SBA as a stockholder, cannot be replaced by a set of arbitrary, severely restrictive rules.

Once again, I would like to stress the importance of maintaining a viable set of regulations within which MESBIC's can operate successfully. Certain financial decisions must be left to the MESBIC manager and the minority entrepreneur in order to construct each deal to the maximum utility of all parties concerned. An arbitrary set of regulations simply cannot perform this function.

Thank you.

Mr. MITCHELL. Thank you very much, Mr. Thompson.

And now, we will hear from Mr. Lee.

TESTIMONY OF JOHN C. LEE, PRESIDENT, EQUITABLE CAPITAL CORP., SAN FRANCISCO, CALIF.

Mr. LEE. Good afternoon, Chairman Mitchell and members of the committee. I am John C. Lee, president of Equitable Capital Corp. in San Francisco.

Equitable Capital Corp. is a MESBIC licensed by the SBA in August 1979 with $505,000 in private paid in capital and has leveraged to date $1 million from the SBA.

There are no specific restrictions to the types of businesses that Equitable Capital Corp. will consider. The following are examples of businesses represented in the Equitable Capital portfolio:

Computer services; accounting firms; import-export: mainland China, and Far East countries to U.S.A.; medical offices: orthopedic surgeons to physical therapy; fertilizers-soils-packaging; aviation fuel service and aircraft repairs and service; expresso coffee shops; pizza restaurant-frozen pizza for retail sales at stores such as Safeway and Lucky Supermarkets; Broadcast Communications Co.; high quality film processing retail store: 1-Hour Film Lab; Real Estate Investment & Development Co.

While our investments are mainly in the San Francisco Bay Area, we will invest anywhere in the California area. The assets of our portfolio companies are now worth approximately $7 million.

Since Equitable Capital Corp. has invested in these small business concerns, it has created approximately 50 to 60 full-time jobs which were nonexistent before our financings.

Equitable Capital Corp. has been fortunate to be profitable in our operations from our first year and consequently has declared dividends to the SBA and our private shareholders annually. In our third year of operations, we were able to declare 11 percent return on investment after expenses and taxes.

Our real estate development company named Diamondhead, Inc., has developed a site of 2 acres in downtown Petaluma and has an approved subdivision of 53 condominiums for the elderly citizens.

The small business concern will dedicate two condominiums at no charge to the city for their low-cost elderly housing program. Through Equitable Capital Corp.'s investment and equity position, the project has generated approximately $125,000 in municipal permit fees, $2 million in construction costs and much needed housing at reasonable and affordable prices ranging from $57,500 to $75,000 as well as a new tax base of approximately $4 million.

This property will create jobs for the construction trade, use raw materials and use finished materials and products for the furnishing of the condominiums. This investment in private dollars will be multiplied to $40 million through the supply and service pipelines of private industries.

In reference to the proposed revision No. 6 of the SBA regulations, these drastic changes being made arbitrarily by the SBA will force numerous SBIC's out of business. Supplying venture capital is a high-risk business with many failures. Not having the flexibility to structure deals and passing the costs to the borrower will be counterproductive.

With Government talk of simplifying and deregulating redtape, revision No. 6 causes more problems then it tends to correct. Presently, the policies of most banks, savings and loans and financial institutions are to make shorter term loans with variable interest rates and money costs to be passed through to the borrower. The SBA is asking just the opposite from the SBIC industry to invest for longer periods of financings and to restrict their yields.

If these regulations are implemented, the negative impact on the SBIC industry will be very damaging and will force many SBIC's and their portfolio companies out of business. I therefore recommend that these regulations in revision No. 6 not be adopted.

Thank you.

[Mr. Lee's prepared statement follows:]

PREPARED STATEMENT OF JOHN C. LEE, PRESIDENT, EQUITABLE CAPITAL CORP., SAN FRANCISCO, CALIF.

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In reference to the proposed Revision No. 6 of the SBA Regulations, these drastic changes being made arbitrarily by the SBA will force numerous SBIC's out of business. Supplying venture capital is a high risk business with many failures. Not having the flexibility to structure deals and passing the costs to the borrower will be counter productive. With governmental talk of simplifying and deregulating red tape, Revision No. 6 causes more problems then it tends to correct. Presently the policies of most banks, savings and loans, and financial institutions are to make shorter term loans with variable interest rates and money costs to be passed through to the borrower. The SBA is asking just the opposite from the SBIC industry to invest for longer periods of financings and to restrict their yields.

If these regulations are implemented, the negative impact on the SBIC industry will be very damaging and will force many SBIC's and their portfolio companies out of business. I therefore, recommend that these regulations in Revision No. 6 not be adopted.

Mr. MITCHELL. Thank you very much, and thank all three of you. I feel a little frustrated right now in the sense that I would like to move, as chairman of this committee, immediately into this whole business of regulations.

I will live with my frustration for a while to see how it is moving. It was August when the regulations came out, and there was a 90-day comment period, correct?

Ms. THOMAS. No, the comment period was over October 15. I know that both MESBIC and AAMESBIC officials will be meeting with the SBA early in December, and I believe that the SBA's Administrator indicated he wanted to try to have the new regulations out by January 15, although that may have been changed.

I have heard rumors, but I am not really sure on that.

Mr. MITCHELL. Well, please keep me abreast. I am serious in hoping some realistic compromises can be worked out, but the alternative, of course, is to approach it on a legislative basis. I really would not like to do that, but if we see something is developing which is inimical to the best interest of the SBIC and MESBIC programs, we have no choice other than to pursue the legislative route.

So, keep us abreast. I must say that I have always championed SBIC's and MESBIC's problems, but in the beginning, I was a little uncomfortable because I thought many of the MESBIC's and SBIC's were being almost as cautious as were the lending institutions when these programs first got started.

I realize we are dealing with other people's money and I realize you want to make the best deal to make a profit, but in the first 1, 2 or 3 years, I was enormously concerned about the slow pace with which packages were put together and loans were made.

However, I think I am right in assuming that in more recent years, that has changed significantly. That the pace of making these loans has increased significantly. I think that is brought out in the testimony from all three of you gentlemen, in fact all four of you. So that fear is somewhat allayed.

My first question is, how quickly can you act on a request? Let me tell you why I want to raise that question. There is no doubt in my mind but that the 97th Congress, in its waning days, or the 98th Congress is going to come up with some sort of job creation bill. There is no question about that.

I assume much of it is going to be in the form of a public works bill of some sort. The Speaker and others, such as Senator Baker, are talking about a bill to develop infrastructure of cities and correct the deficiency in the infrastructure, roads and so forth.

More specifically, I have my little company, Mitchell Construction Co., which does asphalt paving and it has announced, "OK, Mitchell, you can come in and make a bid," but at that particular time, when I need to bid on this public works effort in Baltimore, my capital is just nonexistent, and I am going to need some money very quickly in order to move in to make a bid, and become a part of the development of that infrastructure. Under what kind of timeframe do you generally operate?

Mr. JONES. Mr. Chairman, that varies, of course, with the individual MESBIC. I must tell you that that is a question that we live with every day. From every minority businessperson we talk to the question is, "Well, when can I get an answer?"

In most cases when they come to us, they needed the funds last month, or 6 months ago. In our particular case, we had investment committee meetings every month. That is fairly common in the industry, where proposals are discussed, evaluated, and a decision is made that month. The problem comes in that time frame between the time a minority businessperson comes to us with a request and the time that request is packaged sufficiently to make a formal presentation to our committees.

For instance, it is not unusual for a minority businessperson to come to us with an idea. He may have a company, but he has an idea. We have to then structure a financial program. We have to structure the market and put all the parts of that package together. Depending on how fast he works and what the availability is, that can take anywhere from 30 days to 9 months. Almost no MESBIC will make an investment decision without a formal proposal, a request, past financial statements, some projection of how the company will do, where the growth will come from, and how we get paid. That takes time. That too depends on the minority businessperson and his financial resources.

Mr. MITCHELL. Going back to this Public Works Act, would you consider the possibility of accepting on a priori basis, submissions from businesses that would anticipate that they can take advantage of this program? For example, my little firm—and that is theoretical, since I really don't have a firm—I would not dare have one; there would be all kinds of conflict situations. But let's say my local firm has a good contract; we have been in business 8 years. I don't know how much money will come into Baltimore City, but I do know that whatever money comes in, I want to be a part of it. I want to get a piece of that action.

Is it feasible to consider that I would make that submission to you on that kind of basis—here is my track record; here is what I might be going for. I can't guarantee anything until the law is passed, but I know that I will need this the minute that the law is passed, and my city knows there is *x* amount of dollars coming in. Is it possible to do that kind of thing?

Mr. JONES. Yes, it is, and, in fact, we had been encouraged to have those kinds of proposals where we had time and had a leg up and could get prepared for the time that you would need the financing.

Mr. MITCHELL. Well, I would strongly recommend that the MESBIC association get some notification out to the minority business community, because I see an enormous problem developing in just that one little area with reference to the stimulus to the economy.

I can't demand that you do it, but I would urge that you would at least get information to minority firms that kind of preselecting process is feasible.

Mr. JONES. Your point is well taken, Mr. Chairman.

Mr. MITCHELL. Thank you.

Now, I have just one other question, and that is with reference to franchising.You have made a number of investments in firms that are in the franchising business, and generally they do well. You talked about Chicken George in my own city, which is not only a good business, but it is a civic-minded business. On the day of the election, Chicken George gave free chicken dinners to all people who showed that they had voted.

It is kind of a civic-minded organization. Yet I have some problems with the franchise, particularly for minority businesses. I have a theory that minority businesses need to get as much flow of money within the minority community as they possibly can.

Under franchising, as a general rule, you have your little manual there, and it says if you need mayonnaise, you can only get it from this firm. If you need more paper bags, you can only get it from this firm, and, therefore, those firms may not really be minority firms, and you may have minority firms that can provide the mayonnaise or that can provide the paper bags or the other things.

That is one of my concerns with the franchise of business, and I wanted to get your comment on that, and also to tell you that the House Committee on Government Operations has been very critical of financing franchises. Basically, they suggest that the parent company should use its own resources to finance the purchase of franchises rather than having the prospective franchisee seek SBA assistance; and that the payment of fees to the parent company and the tying of the franchised small business to the parent company is not in the best interest of anyone.

Generally, those are the problems. I want to know how you answer my concerns about franchising. Maybe I'm being selfish, but I want to see the whole minority business community grow. One way that it can grow is for the maker of the franchise of

Burger King to get some supplies from minority firms. How do you respond to that?

Mr. **Jones**. I would agree with you, sir, that the franchising program certainly is not perfect. I would agree with you that the McDonalds of the world and the Burger Kings of the world certainly need to direct more of their mass purchasing from minority companies. In the case of Burger King, I know that there are some discussions along that line. Of course, the franchise source would tell you that they do not control the sources from which their franchisees buy their products.

Mr. **Mitchell**. But that is not true. I should not say it quite that flatly, but it has been my experience that is not true.

Mr. **Jones**. A franchisee absolutely has to buy from an approved source; that is correct.

Mr. **Mitchell**. Sure.

Mr. **Jones**. In our evaluation of it, though, we see that there are at least three issues that a well-established franchise, and I am not talking about every franchise, but I am talking about a well-established franchise system. First, the failure rate of small businessmen, whether they have experience or don't have experience, is enormously high. If you then segment out of that population the minority businessmen who often have no experience to put them in a free-standing, stand-alone business where they are on their own, the risks of failure are astronomical.

We think if you take an established franchise system that has a training program, that has a method of doing business, that you can take an inexperienced, untried but ambitious entrepreneur, put him in that system, and he develops those management techniques.

We think that one of the issues we would like to address in the inner-city, urban areas is unemployment. I think you are aware that the highest level of unemployment is among minority or black teenagers in the inner city. Well, the fast food franchises that we finance employ an average of 60 to 65 minority teenagers in the inner city areas. We think that those are new jobs that are created, and that is a very productive benefit to the community. We also think that the MESBIC program is about bringing minority entrepreneurs into the mainstream of American business to allow some minority entrepreneurs to develop equity interests.

I would like to cite an example of one of our first investments, a man by the name of Herman Petty. He was a barber. He went to work for a partnership of McDonald franchises. He started out as a cook and moved up to a store manager. The partnership fell apart, and he came to the Urban Fund to say, you know, "I would like to try to buy this McDonald's. Can you help me do that?" We worked with him. We structured an acquisition where he bought the first McDonald's franchise of this partnership. About a year later, he bought the second McDonald's franchise of this partnership. Mind you, now, this is a barber who had little or no equity. Herman Petty at least once has been called the "McDonald's Operator-of-the-Year," and he is now in the process of opening his eighth McDonald's.

There was a new cable franchise being issued in the city of Chicago, and Herman was one of the minority entrepreneurs who had enough equity to put up his dollars along with the other minority people and bid on this franchise. We think that is really what the program is all about.

Mr. MITCHELL. I hope I have made myself clear. I am not taking a stand against the franchising. I think it is obviously an excellent way of breaking people into the mainstream. What I am talking about is the possibility of restructuring the franchise so that you have the operations of the franchise so that you get a greater flow of money within the community. That is my only concern.

Mr. Lee, I have just one question for you.

In your prepared statement you mention, "In our third year of operations we were able to declare an 11-percent return on investment after expenses and taxes."

God knows, I am not going to quarrel with it. It just seems extraordinarily high to me that you are able to do this, and I am curious how you are able to do it. That is not normal for the business.

Mr. LEE. That is correct, sir.

Mr. MITCHELL. That is not average at all.

Mr. LEE. We are proud of the fact that we are money managers. We do make very prudent investments. We do help our portfolio companies advance to that stage where they can really pay off, and that is why we have these returns. This is after taxes and after expenses. That is correct. We pay dividends to the SBA first before we pay any shareholder.

Mr. MITCHELL. Well, wouldn't you want to share that with Chrysler, General Motors, and some other people? I really want to compliment you. That is an astounding return, particularly given the economic vicissitudes that confront us right now. You are certainly to be commended.

Mr. LEE. Thank you, Mr. Chairman.

Mr. MITCHELL. Congressman Siljander?

Mr. SILJANDER. I just want to request that Mr. Lee come to Michigan for several years.

I really have no other questions, but just to thank all three of you gentlemen for participating. I have learned quite a bit, and as the minority member of the Small Business Committee, I can relate to some of your interests and needs, and I will be more than happy to work with the chairman in the future on some of the problems, especially on revision 6 as it relates to these new regulations that are being proposed, and I am sure that the SBA Administrator and Director of the SBA would be more than cordial in working out some of the compromises, and I would be more than happy to help in that.

Mr. JONES. Thank you.

Mr. MITCHELL. Thank you very, very much, gentlemen. I hope you make your plane. It is fascinating testimony. It will be completely incorporated for all the Members of the House of Representatives. Thank you very much.

Mr. THOMPSON. Thank you.

Mr. MITCHELL. I am going to consult with my colleagues. We are going to make some decisions here. We have a number of other witnesses. I suppose we can make a determination as to whether we want to proceed straight through and get all the witnesses in, or whether we would want to take a luncheon break.

How many other witnesses are in the room?

[Show of hands.]

Mr. MITCHELL. Our last witness is due in at 1 o'clock.

Gentlemen, before we hear from any more witnesses I think it would be appropriate for us to take a short recess. One of the Congressmen has just flown in, and has not had sustenance yet. We want him to be strong for the hearing.

Is it convenient to you for us to resume at 1 o'clock? That is about a 25-minute break. Is that convenient?

VOICES. Yes.

Mr. MITCHELL. Thank you very much. The hearing will recess until 1 o'clock. Thank you.

[Whereupon, at 12:35 p.m. the subcommittee recessed until 1:15 p.m. the same afternoon.]

AFTERNOON SESSION

Mr. MITCHELL. I think we are just about ready to get started now. We would now like to hear from our next panel of witnesses, and that is Ralph Gabai, Gerard Currie, and Gary Kalbach. If you three gentlemen would come right up here we would appreciate it, and we can get started with your testimony.

Gentlemen, thank you very much for taking time from your busy schedules to be with us. In the years that I have been on the House Small Business Committee I have found that field hearings are more informative and productive than the hearings that we conduct in Washington. That is why I made a commitment when I assumed the chairmanship that we would step up the pace of our field hearings.

We have copies of your written testimony, and we will now hear your testimony and proceed in any order that you so desire.

PANEL CONSISTING OF GERARD CURRIE, RALPH GABAI, AND GARY W. KALBACH

TESTIMONY OF GERARD CURRIE, PRESIDENT, CENTIGRAM CORP.

Mr. CURRIE. Mr. Chairman, my name is Gerry Currie. I am president of Centigram Corp. It is a pleasure and a privilege to have the opportunity to testify here today on the role that SBA has played in helping Centigram Corp. survive, and we hope soon to be very prosperous.

You hear a lot spoken about the glorious successes of venture capital: the Intels, and Apple Computers which grew from zero to $1-billion-per-year enterprises. For each of these "grand slams" there exist 10 or more companies like Centigram who have struggled, continue to struggle to make a modest success. It is these companies that need not only the initial investment from venture capital companies, but second- and third-round financings in order to survive in the short term to enjoy the fruits of their labors in the long term. Centigram is such a company which after 2 years of venture capital money, and second- and third-round financings is finally operating at breakeven with a lot of help, both financial and advisory, from our venture capital friends, and is immediately going to become very profitable.

Centigram Corp. was formed in 1977 by four engineers pooling their resources and setting up in business in a garage to work in the area of speech recognition. The first product was to be a toy dog which responded to spoken commands of his master's voice. Unfortunately the technology required the cost of the product to be so high as to price it out of the toy market. The company then reoriented its product development toward the industrial market, that is, voice input to command and control a computer.

Although a potentially enormous market, the concept of talking to computers has many, as-yet-unsolved, technical problems. They work most of the time with most of the people. To be truly effective they must work all of the time with all of the people. This is not technically solved as yet either here in America or in Japan.

The Centigram product, along with its two or three competitors, had very limited market acceptance, and by early 1980 had lost $800,000 and was virtually bankrupt and down to four employees. At this critical date enter the white knights, namely two venture capitalists, Northwest Growth Fund and Northstar Ventures, who together with myself, G. Currie, and SCI, a Palo Alto corporation, invested $1.1 million to buy out the old shareholders, retain three of the old technical staff, installed new management, and resurrected the company. In return for the $1.1 million of convertible preferred stock, the venture capitalists obtained 85 percent of the company, with 15 percent being reserved for key employees via stock option. The dividends on the convertible preferred were deferred for 2 years to minimize cash outflow from the corporation. This refinancing was closed September 4, 1980.

The company proceeded to redesign the voice recognition product and started work on some computer output products; namely, the computer talking to you, particularly to prompt and guide you into how to use the computer. Product development of the computer output products, as is often the case, took longer than expected, and the redesigned voice recognition unit sold below expectations. It was obvious by late 1981 that additional funding would be required. At this time the company started preparing a revised business plan for obtaining an additional $3.3 million of equity capital. Substantial time and effort was expended by the two venture capitalists in reviewing and assisting in the preparation of the business plan to so structure it that other venture capitalists would understand and appreciate the potential of the company and the uniqueness of its technology and of the investment opportunity. After all, it takes one to sell one.

By the end of 1981 Centigram was out of the original $1.1 million and needed additional funding pending receipt of funds from the refinancing. Bank loans were sought but were not obtainable because of the loss history and the small market acceptance of the products. The SBIC's loaned the corporation $1.5 million which they subsequently converted into convertible preferred with again a 2-year deferral of dividends.

The SBIC's besides assisting in the preparation of the business plan were instrumental in organizing a presentation of our products at a NASBIC convention. At this meeting we presented our story to more than 100 SBIC's, out of which we got 20 interested parties. We subsequently closed four new venture capital organizations for a total of $1.55 million. A significant factor in the close was the fact that the original investors had come up with $1.5 million in loans which was to be converted into convertible preferred on basically the same terms as the new investors.

Recognizing that one of the problems of Centigram Corp. was excellent technology but poor marketing, the VC's suggested that we should make an effort to recruit as one of the investors a major corporate entity with more marketing muscle than we have. They arranged for us to meet with the right people at General Instruments, a $1 billion-per-year electronics concern, who could not only make an equity investment but could also help sell our products more effectively than we can. This was accomplished, and we expect next year to ship more than $2 million through this one customer. The refinancing was completed in July 1982. Since that time, the company's prospects have improved substantially. Employment is now up to 30 people, and like many people in Silicon Valley we contract out most of our assembly, which supports another 10 people full time. The company will be at approximately breakeven in November, and at $300,000 shipments in December, will show for the first time a small profit. Expected sales of $4 million in 1983 should insure profitable operations, and we expect to end the year with at least 50 direct employees and 20 indirect in assembly subcontracting. We now have a reasonable chance to grow at 100 percent per year in both sales and employment, because widespread acceptance of our products has started.

In conclusion, it is fair to say that although our wildest dreams have not been realized, notable achievements have been made, that is, Centigram is now recognized as a technological leader in the critical area of voice output for computers. Centigram is now a viable growing entity which provides well-paid, interesting jobs on a nondiscriminatory basis to a growing number of people. It is interesting to note that not one employee has resigned since we were refinanced in September 1980.

This could not have been achieved without the original capital from the VC's, together with their assistance, support, and faith in selling the deal to fellow VC's. Thirty employees are working very hard to repay the debt owed to the VC's.

Thank you very much.

[Mr. Currie's prepared statement follows:]

Prepared Statement of Gerard Currie, President, Centigram Corp.

It is a pleasure and a privilege to have the opportunity to testify here today on the role that SBIC's have played in helping Centigram Corp. survive, and we hope, soon prosper. You hear a lot spoken about the glorious successes of venture capital, the Intels and Apple Computers which grew from zero to $1 billion per year enterprises. For each of these "grand slams," there exist 10 or more companies like Centigram who have struggled, continue to struggle to make a modest success. It is these companies that need not only the initial investment from venture capital companies, but second and third round financings in order to survive in the short term to enjoy the fruits of their labors in the long term. Centigram is such a company which after 2 years of venture capital money and second and third round financings is finally operating at breakeven with a lot of help, both financial and advisory, from our venture capital friends and is immediately going to become very profitable.

Centigram Corporation was formed in 1977 by four engineers pooling their resources and setting up in business in a garage to work in the area of speech recognition. The first product was to be a toy, a dog which responded to spoken commands of his master's voice. Unfortunately the technology required the cost of the product to be so high as to price it out of the toy market. The company then reoriented its product development toward the industrial market, i.e. voice input to command and control a computer. Although a potentially enormous market, the concept of talking to computers has many as yet unsolved technical problems. They work most of the time with most of the people. To be truly effective they must work all of the time with all of the people—this is not technically solved as yet here in America or in Japan. The Centigram product (along with its two or three competitors) had very limited market acceptance and by early 1980 had lost $800,000 and was virtually bankrupt and down to 4 employees. At this critical date enter the white knights, namely two venture capitalists, Northwest Growth Fund and Northstar Ventures, who together with myself, G. Currie, and SCI, a Palo Alto corporation, invested $1 million to buy out the old shareholders, retain 3 of the old technical staff, and installed new management and resurrected the company. In return for the $1 million of convertible preferred stock, the venture capitalists obtained 85 percent of the company with 15 percent being reserved for key employees via stock option. The dividends on the convertible preferred, were deferred for 2 years to minimize cash out-flow from the corporation. This refinancing was closed September 4, 1980.

The company proceeded to redesign the voice recognition product and started work on some computer output products, i.e. the computer talking to you—particularly to prompt and guide you into how to use the computer. Product development of the computer output products is often the case took longer than expected and the redesigned voice recognition unit sold below expectations. It was obvious by late 1981 that additional funding would be required.

At this time the company started preparing a revised business plan for obtaining an additional $3.3 million of equity capital. Substantial time and effort was expended by the two venture capitalists in reviewing and assisting in the preparation of the business plan so as to structure it so that other venture capitalists would understand and appreciate the potential of the company and the uniqueness of its technology and of the investment opportunity. After all it takes one to sell one.

By the end of 1981 Centigram was out of the original $1.1 million and needed additional funding pending receipt of funds from the refinancing. Bank loans were sought but were not obtainable because of the loss history and the small market acceptance of the products. The SBIC's loaned the corporation $1.5 million which they subsequently converted into convertible preferred with again a 2-year deferral of dividends.

The SBIC's besides assisting in the preparation of the business plan were instrumental in organizing a presentation of our products at a NASBIC convention. At this meeting we presented our story to more than 100 SBIC's out of which we got 20 interested parties. We subsequently closed four new venture capital organizations totaling $1.55 million. A significant factor in the close was the fact that the original investors had come up with $1.5 million in loans which was to be converted into convertible preferred on basically the same terms as the new investors.

Recognizing that one of the problems of Centigram Corp. was excellent technology but poor marketing, the VC's suggested that we should make an effort to recruit as one of the investors a major corporate entity with more marketing muscle than we have. They arranged for us to meet with the right people at General Instruments, a $1-billion-per-year electronics concern, who could not only make an equity investment but could also help sell our products more effectively than we can. This was accomplished and we expect next year to ship more than $2 million through this one customer.

The refinancing was completed in July 1982. Since that time the companies' prospects have improved substantially. Employment is now up to 30 people and, like many people in Silicon Valley, we contract out most of our assembly which supports another 10 people full time. The company will be at approximately breakeven in November, and at $300,000 shipments in December, will show for the first time a small profit. Expected sales of $4 million in 1983 should insure profitable operations and we expect to go out of the year with at least 50 direct employees, and 20 indirect in assembly subcontracting. We now have a reasonable chance to grow at 100 percent per year in both sales and employment because there has started to be widespread acceptance of our products.

In conclusion it is fair to say that although our wildest dreams have not been realized, notable achievement have been made, that is Centigram is now recognized as a technological leader in the critical area of voice output for computers, and Centigram is now a viable growing entity which provides well paid, interesting jobs on a nondiscriminatory basis to a growing number of people. It is interesting not one employee has resigned since we were refinanced in Sept. 1980.

This could not have been achieved without the original capital from the VC's together with their assistance, support and faith in selling the deal to fellow VC's. Thirty employees are working very hard to repay the debt owed to the VC's.

Mr. MITCHELL. Thank you. We have some questions. We would like to hear from all of the witnesses first, and then we will put our questions, if that is all right.

TESTIMONY OF RALPH GABAI, CHAIRMAN, MICRO PERIPHERALS, INC., CHATSWORTH, CALIF.

Mr. GABAI. My name is Ralph Gabai, and I am chairman and chief executive officer of Micro Peripherals, Inc., in the Los Angeles area. Micro Peripherals was founded in May 1977 with a principal charter of development, manufacturing, and marketing of small computer peripheral equipment, primarily for the storage of computer information and records. The initial products that were produced were flexible disk drives, commonly referred to as floppy disks, and they were really aimed at meeting the storage capacity requirements of small microcomputer-based systems. Initial applications of our product lines are in word processing, very small business machines, and communications. With the advent of personal computers, many of our products are in people's homes, which is quite a departure for many of us in the computer business. Throughout MPI's corporate history to date, we have been financed by several venture capital firms who have made total investments of $12 million in the company. Of this amount, over 30 percent or approximately $4 milllion of the investments came from small business investment companies, specifically West Coast Venture, First Interstate Venture, Union Venture, Menlo Venture, and Novus Capital.

Capital requirements for the first 3 years of the company's existence was needed for both product and market development. The capital infusion was utilized to finance research and development, marketing, and initial production needs. In the past 2 years, the company has grown from monthly sales of approximately $1 million per month to over $3 million per month, and during this current fiscal year ending next April 30 we will achieve revenues of almost $40 million. The capital investment required during the past 2 years has been needed to finance the purchase of fixed assets to expand production, higher levels of inventory, and accounts receivable to meet these achievements. The company I believe would not exist today had it not been for the financial and advisory support given by the above-mentioned SBIC's. Things like control of inventory, midrange financial programs, were the kinds of things that the individuals were helpful to provide to me.

Last year Micro Peripherals, Inc., broke into profitability. Additionally, during this period of rapid growth, we have created over 700 jobs worldwide. I am in fact delighted to say that as a corporation, we will be paying Federal income taxes by the end of this fiscal year.

Mr. MITCHELL. You are the second one today.

Mr. GABAI. Good. One of the First three investors in Micro Peripherals, Inc., was West Coast Venture Capital, managed by Gary Kalbach. Gary made an investment when our sales were approximately $50,000 a month. So we have come a long way.

I have learned from Gary that because of regulatory reasons, SBIC programs themselves are becoming less effective, and I am concerned about it for a few reasons. I often get on this soapbox. I do not want to overdwell on it, but let me say that so many of our industries are under pressure from foreign competition for a lot of different reasons, but generally in our industry most of the foreign nations are seeking access to American markets, while they have their own markets protected. While I like free trade in both directions, it is not that way today, and those of us who are in high-technology industries feel proud that from a standpoint of our economy, we are a net exporter as it relates to balance of payments and balance of trade, and we would like to keep it that way. We are a group of talented innovators with bright ideas. The "Apples" of our industry which were mentioned are the epitome of success, and certainly firms like mine are not as dramatic, but certainly have grown into medium size were really able to put these ideas into practice with the help of SBIC investments.

It is my view and the view of other companies who engage in studies like the REA that much of the job creation required in this country will come about not from the large mature businesses but really from firms that employ 500 people or less, and high technology industries are clearly a part of that segment, and I would hope that this administration's policy would do everything it could to increase and expand our investment in high-technology companies.

I would encourage this committee with due respect to do everything in its power to allow small business investment companies to expand and continue their efforts to support high-technology companies like Micro Peripherals. I would tell you that we could not be here today if it were not for the help that they provided us.

Thank you very much.

Mr. MITCHELL. Thank you.

[Mr. Gabai's prepared statement follows:]

PREPARED STATEMENT OF RALPH GABAI, CHAIRMAN, MICRO PERIPHERALS, INC.

Micro Peripherals, Inc. was founded in May 1977 with the principal mission of developing, manufacturing, and marketing small computer peripheral equipment for the storage of information. Initial products produced were flexible disk drives, commonly called "floppy disks," aimed at meeting the storage needs of small microcomputer based systems. Initial applications included word processing, small business systems, and communications equipment. Additionally, our products have started to appear in the homes of many people in America via the recent surge of personal and home computer systems.

Throughout MPI's corporate history to date, we have been financed by several venture capital firms who have made total investments of $12 million in the company. Of this amount over 30 percent, or approximately $4 million of the investments, came from Small Business Investment Companies specifically, West Coast Venture, First Interstate Venture, Union Venture, Menlo Venture, and Novus Capital.

Capital requirements for the first 3 years of the company's existence was needed for both product and market development. The capital infusion was utilized to finance research and development, marketing, and initial production needs. In the past 2 years, the company has grown from monthly sales of approximately $1 million per month to over $3 million per month and during this current fiscal year ending next April 30, we will achieve revenues of almost $40 million. The capital investments required during the past 2 years has been needed to finance the purchase of fixed assets to expand production, higher levels of inventory and accounts receivable to meet these achievements. The company I believe would not exist today had it not been for the financial and advisory support given by the above mentioned SBIC's.

Last year Micro Peripherals, Inc. broke into profitability. Additionally, during this period of rapid growth, we have created over 700 jobs worldwide. I am in fact delighted to say that as a corporation, we will be paying Federal income taxes by the end of this fiscal year. One of the first three investors in Micro Peripherals, Inc. was West Coast Venture Capital managed by Gary Kalbach. As I understand it, West Coast is being driven out of SBIC investments because of regulatory reasons, which are making the total SBIC program less effective. I am personally concerned about this for several reasons.

Many of America's industries are under extreme pressure and in some cases facing extinction as a result of foreign competition. Specifically those countries have protected their own markets while they have endorsed policies to aggressively seek out large shares of the American marketplace. While I, for one, endorse free trade both ways, it is very clear that this situation does not exist today.

Those of us in high technology industries are proud to be a segment of our economy that is a net exporter as it effects our balance of payments. Much of this phenomena has come about through the innovation of talented individuals who were able to put their ideas into practice with the help of SBIC investments.

Much of the job creation required in our country will not come from corporate giants whose employment levels are rather stable and whose business is mature. Studies conducted by the American Electronics Association have verified that growth in jobs in America come from companies which employ 500 people or less.

High technology industries are part of this high growth segment and it should be this administration's policy to do everything it can to increase and expand American investment in high technology to assure continued future growth.

I encourage this committee to do everything in its power to allow Small Business Investment Companies to expand and continue their good efforts in supporting the start up of high technology companies. As chairman of Micro Peripherals, Inc. I can assure this committee that we could not be here today were it not for their support of our company.

Mr. MITCHELL. Now we will hear from the last member of this panel and your supporter in early days, Mr. Gary Kalbach.

TESTIMONY OF GARY W. KALBACH, GENERAL PARTNER, WEST COAST VENTURE CAPITAL, SAN JOSE, CALIF.

Mr. KALBACH. Thank you. Mr. Chairman and members of the committee; my name is Gary Kalbach. I am the sole general partner of West Coast Venture Capital, a privately owned small business investment company in San Jose, Calif.

I would like to give you a little background about West Coast Venture Capital. West Coast was organized in late 1978 as a limited partnership and licensed as a SBIC in early 1979. It was the first regular limited partnership licensed as a SBIC under the program. There are 12 limited partners who have contributed $2.7 million in private capital and committed an additional $2.7 million of guarantees to the licensee. The limited partners of West Coast are all successful entrepreneurs from the Santa Clara Valley who have a strong desire to recycle some of their net worth into startup, technology-based companies. West Coast was formed with the philosophy of making equity-oriented investments in technology-based companies exclusively.

The limited partners of West Coast were motivated to fund the partnership largely in anticipation of favorable capital gains treatment of any successful equity-oriented investment. The SBIC license was sought in order to achieve a maximum leverage on equity funds from these private individuals. It was our philosophy that a partnership of Government leverage, together with private entrepreneurial capital, could be invested into startup companies on an equity basis in order to stimulate rapid growth companies which would result in the expansion of technology, the increase of jobs, the increase of corporate taxes, and ultimately a profit for the limited-partner investors.

In 4 years of operation, West Coast has invested approximately $7 million into 11 startup technology-based companies. West Coast has actually stimulated the formation of 5 of these 11 companies. The financing of these companies by West Coast and other venture capitalists can account for approximately 800 new jobs in the United States.

The value of these investments by West Coast over the past 4 years has increased by approximately 35 percent compounded per annum. One company, Onyx Systems, was started with a $250,000 investment by West Coast in 1979. Last year Onyx was merged with an affiliated company, and successfully sold stock in the public market. Today Onyx has a market value in excess of $140 million. Another company, Integrated Device Technology of Santa Clara, Calif., is manufacturing semiconductors using an advanced semiconductor process which results in products which actually outperform the Japanese semiconductor industry. Today IDT is shipping products for key military and commercial application. IDT employs 150 people today. These 11 companies were financed with funds provided by the partnership of successful entrepreneurs from the Santa Clara Valley, together with Government funds provided under the SBIC program.

West Coast has been proud of its record as a SBIC where, during its regular annual audits, there have been no major regulatory violations. During the past 11 months, West Coast has experienced a dramatic change in the administration of the SBIC program: SBA has reneged on its commitment to West Coast relative to defining our regulatory capital established for equity-oriented investments. The SBA has denied leverage to West Coast because the licensee was "equity-oriented." The office of the SBA Administrator has been unresponsive to repeated requests for assistance.

The SBA has forced West Coast to accept a unique leverage agreement which exemplifies a new debt orientation of the SBIC program in spite of the previous commitments to an equity-oriented program.

Because of the change in administration and emphasis in the SBA relative to the SBIC program, West Coast has become inactive in its investment program, and I personally am currently in the process of leaving West Coast to establish a new non-SBIC venture capital group.

The funding for this new venture capital group will likely come from some foreign sources. It seems ironic that in order to fund a new venture capital investment company which will foster high-technology growth in the United States, one must turn to foreign investors. I believe, further, that the current administration of the SBIC program as a debt-oriented program will force other equity-oriented venture capital managers to also leave the program. It is clear that under present administration, the program will not work for equity investment portfolios.

West Coast was formed with the philosophy of making equity-oriented investments in technology-based companies. Such investments require extraordinary attention to insure success. We take a very active role as directors and advisers in all of our investments.

We therefore believe our efforts must be concentrated in fewer investments and that we must have the financial resources to support the successful growth of emerging companies such as MPI. With this philosophy we proposed to the SBA in 1978, through numerous discussions and correspondence, a capital structure that would provide a base for additional overline investment purposes under the SBIC program represented by notes from our limited partners backed by irrevocable letters of credit. We were licensed by the SBA with the clear understanding that these notes were for the protection of the SBA as a creditor.

The licensees original paid-in capital was $850,000. Through sale of distributed stock, an additional $1.7 million has been paid in over the past 4 years. On at least nine occasions, correspondence between the SBA and West Coast reiterated our unique capital position together with our increased capital.

On December 7, 1981, the SBA notified us without warning they would no longer maintain their commitment for our capital structure. Through a number of discussions, and one visit to the SBA, they refused to reconsider their position, forcing us to a unique and unacceptable investment philosophy. The SBA withheld needed guaranteed funds for investment from West Coast in order to force an acceptance of their position.

During mid-1982 on no less than nine occasions, repeated telephone calls to the Administrator's office requesting a meeting to discuss the situation resulted in no response. A final, desperate express letter to James Sanders, Administrator of the SBA on July 19, 1982, requesting a personal meeting in his office at his convenience was responded to in mid-August from one of his Deputy Administrators explaining that there was no need for the meeting.

On July 16, 1982, the SBA denied an application for guarantee to West Coast Venture Capital in the amount of $1.5 million on the basis that,

> * * * the portfolio of West Coast consists primarily of equity investments. * * * Therefore it does not appear that the licensee will have sufficient cash income to cover its debt service.

It is hard to believe a position more inconsistent with the statutory intent of the SBIC program as we understand it. West Coast in its initial "plan of operation," filed with its license application on May 19, 1978 said:

> Applicant * * * will emphasize equity investments, with particular interests toward startup situations.

The July 16, 1982 denial letter from the SBA went on to request further that we provide a 5-year cash flow projection of our investment activity which by definition would be a 5-year forecast of the equity markets of the U.S. economy. Such a forecast would show exactly when we would make investments over the next 5 years and when these companies would be sold in the equity markets. To project investment opportunities as well as public markets over the next 5 years is frankly beyond my personal abilities. It demonstrates a complete lack of understanding by the SBA of the venture capital process.

To insure operation as a more "debt-oriented" investor the SBA proposed that we sign a "leverage agreement," similar to a loan agreement provided many banks to its borrowers. This agreement was structured with various financial ratios which insure that West Coast will be in default by Dec. 31, 1982, allowing the SBA the option of withholding further leverage, as well as taking other actions to insure that the activities of West Coast as an equity-oriented investor will be stopped forever.

It is our understanding that a number of other equity-oriented SBIC's are denied leverage until they sign an identical leverage agreement with the SBA.

In summary, Mr. Chairman and members of the committee, it is unfortunate that the current administration of the SBIC program has forced equity-oriented investors such as West Coast Venture Capital to actually change its investment emphasis to debt-oriented programs, or to cease its investment activities.

During this particularly tenuous time of economic recovery when jobs should be created, taxes should be generated, and technology should be stimulated, the administrators of the SBIC program have taken it upon themselves to change the emphasis of this worthwhile and proven program over the past 11 months to the point of forcing West Coast Venture Capital out of business as an equity-oriented investor.

Thank you, Mr. Chairman.

[Mr. Kalbach's prepared statement follows:]

Prepared Statement of Gary W. Kalbach, General Partner, West Coast Venture Capital, San Jose, Calif.

My name is Gary Kalbach. I am general partner of West Coast Venture Capital, a privately-owned Small Business Investment Company in San Jose, California.

I'd like to give you a little background about West Coast Venture Capital. West Coast was organized in late 1978 as a limited partnership and licensed as an SBIC in early 1979. It was the first regular limited partnership licensed as an SBIC under the program. There are twelve limited partners who have contributed $2.7 million of private capital and committed an additional $2.7 million of guarantees to the licensee. The limited partners of West Coast are all successful entrepreneurs from the Santa Clara Valley who have a strong desire to "recycle" some of their net worth into startup, technology-based companies. West Coast was formed with the philosophy of making equity-oriented investments in technology-based companies exclusively. The limited partners of West Coast were motivated to fund the partnership largely in anticipation of favorable capital gains treatment of any successful equity-oriented investment. The SBIC license was sought in order to achieve a maximum leverage on equity funds from these private individuals. It was our philosophy that a partnership of government leverage, together with private entrepreneurial capital could be invested into startup companies on an equity basis in order to stimulate rapid growth companies which would result in the expansion of technology, the increase of jobs, the increase of corporate taxes and ultimately profit for the limited partner investors.

In 4 years of operation, West Coast has invested approximately $7 million into eleven startup technology-based companies. West Coast has actually stimulated the formation of five of these eleven companies. The financing of these companies by West Coast and other venture capitalists can account for approximately 800 new jobs in the United States. The value of these investments by West Coast over the past 4 years has increased by approximately 35 percent compounded per annum. One company, Onyx Systems, was started with a $250,000 investment by West Coast in 1979. Last year Onyx was merged with an affiliated company and successfully sold stock in the public market. Today, Onyx has a market value in excess of $140 million. Another company, Integrated Device Technology of Santa Clara, California is manufacturing semiconductors using an advanced semiconductor process which results in products that actually outperform the Japanese semiconductor industry. Today IDT is shipping products for key military and commercial application.

These eleven companies were financed with funds provided by the partnership of successful entrepreneurs from the Santa Clara Valley, together with Government funds provided under the SBIC program.

West Coast has been proud of its record as an SBIC where, during its regular annual audit, there have been no major regulatory violations.

During the past 11 months, West Coast has experienced a dramatic change in the administration of the SBIC program.

The SBA has reneged on its commitment to West Coast relative to defining our regulatory capital established for equity-oriented investments.

The SBA has denied leverage to West Coast because the licensee was "equity-oriented."

The office of the SBA Administrator has been nonresponsive to repeated requests for assistance.

The SBA has forced West Coast to accept a unique leverage agreement which exemplifies a new debt-orientation of the SBIC program in spite of the previous commitments to an equity-oriented program.

Because of the change in administration and emphasis in the SBA relative to the SBIC program, West Coast has become inactive in its investment program and I personally am currently in the process of leaving West Coast to establish a new non-SBIC venture capital group.

The funding for this new venture capital group will likely come from some foreign sources. It seems ironic that in order to fund a new venture capital investment company which will foster high technology growth, one must turn to foreign investors. I believe, further, that the current administration of the SBIC program as a debt-oriented program will force other equity-oriented venture capital managers to also leave the program. It is clear that under present administration, the program will not work for equity investment portfolios.

West Coast was formed with the philosophy of making equity-oriented investments in technology-based companies. Such investments require extraordinary attention to ensure success; therefore, we believe our efforts must be concentrated in fewer investments and that we must have the financial resources to support the successful growth of emerging companies such as MPI. With this philosophy we proposed to the SBA in 1978, through numerous discussions and correspondence, a capital structure that would provide a base for additional overline investment purposes under the SBIC program represented by notes from our limited partners backed by irrevocable letters of credit. We were licensed by the SBA with the clear understanding that these notes were for the protection of the SBA as a creditor.

The licensees original paid-in capital was $850,000. Through sale of distributed stock, an additional $1.7 million has been paid in over the past 4 years. On at least nine occasions, correspondence between the SBA and West Coast reiterated our unique capital structure which was in place for the benefit of the SBA as a creditor.

On Dec. 7, 1981, the SBA notified us without warning that they would no longer maintain their commitment for our capital structure. Through a number of discussions, and one visit to the SBA, they refused to reconsider their position, forcing us to a unique and unacceptable investment philosophy.

The SBA withheld needed guaranteed funds for investment from West Coast in order to force an acceptance of their position.

During mid-1982 on no less than nine occasions, repeated telephone calls to the Administrator's office requesting a meeting to discuss the situation resulted in no response. A final, desperate certified letter to Mr. James Sanders, Administrator of the SBA, on July 19, 1982 requesting a personal meeting in his office at his convenience was responded to in mid-August from one of his Deputy Administrators explaining that there was no need for the meeting.

On July 16, 1982, the SBA denied an application for guarantee to West Coast Venture Capital in the amount of $1.5 million on the basis that,

> The portfolio of West Coast consists primarily of equity investments. * * * Therefore, it does not appear that the licensee will have sufficient cash income to cover its debt service.

It is hard to believe a position more inconsistent with the statutory intent of the SBIC program as we understand it. West Coast in its initial "plan of operation," filed with its license application on May 19, 1978 said,

> Applicant * * * will emphasize equity investments, with particular interests toward startup situations.

The July 16, 1982 denial letter from the SBA further went on to request that we provide a 5-year cash flow projection of our investment activity which by definition would be a 5-year forecast of the equity markets of the U.S. economy. Such a forecast would show exactly when we would make investments over the next 5 years and when these companies would be sold in the equity markets. To project investment opportunities as well as public markets over the next 5 years is frankly beyond my personal abilities. It demonstrates a complete lack of understanding by the SBA of the venture capital process.

To ensure operation as a more "debt-oriented" investor the SBA proposed a "leverage agreement" similar to a loan agreement provided many banks to its borrowers. This agreement was structured with various financial ratios which ensure that West Coast will be in default by December 31, 1982, allowing the SBA the option of withholding further leverage, as well as taking other actions to ensure that the activities of West Coast an an equity-oriented investor will be stopped forever.

It is our understanding that a number of other equity-oriented SBIC's are denied leverage until they sign the identical leverage agreement with the SBA.

In summary, it is unfortunate that the current administration of the SBIC program has forced equity-oriented investors such as West Coast Venture Capital to actually change its investments emphasis to debt-oriented programs or to cease its investment activities.

During this particularly tenuous time of economic recovery when jobs should be created, taxes should be generated, and technology should be stimulated, the administrators of the SBIC program have taken it upon themselves to change the emphasis of this worthwhile and proven program over the past 11 months to the point of forcing West Coast Venture Capital out of business as an equity-oriented investor.

Mr. MITCHELL. Thank you. Your testimony to me was most distressing. I asked Tom Powers, to my right, that the staff look into West Coast's situation with SBA. SBA has apparently taken the position that it is a closed issue, but based just on the testimony—and I stress that is just on your testimony—I think we have seen a series of rather arbitrary actions taken which, in my opinion, fly in the face of what the Congress intended these programs to be.

Above and beyond that, earlier witnesses today talked about some proposed regulations that were issued in August, and now that the comment period is over with, and they are still under discussion—I do not know whether you were here earlier today or not—but it appears to me that those proposed regulations were imposed on your firm even before they had gone through the process. That is just from the top of my head, but that is the way it seems to me what did happen.

Now, you are definitely going to close that business?

Mr. KALBACH. Yes; I actually formally left West Coast as an employee earlier this month. I am still a partner, and we are trying to figure out how to wind down, but we are not making any formal investments.

Mr. MITCHELL. Am I right in stating that the primary reason for closing down West Coast is the decision made by the Small Business Administration with reference to a shift from equity venture capital into debt?

Mr. KALBACH. That is right. That is exactly right. It is the only reason I am leaving West Coast, and the only reason that we have stopped our investment activity.

Mr. MITCHELL. That is amazing.

Mr. KALBACH. Yes, it is.

Mr. MITCHELL. You gave this in your testimony, but how many companies have you helped?

Mr. KALBACH. We have participated in financing 11; we actually started 5. We were only a participant in the MPI financing, but we started five companies, one of which is Onyx Integrated Device, the semiconductor company, and three others, all of whom are successful.

Mr. **Mitchell**. Your last letter which was sent directly to the Administrator was not answered by the Administrator?

Mr. **Kalbach**. No, it was not. In fact, I have copies of all the letters with me, if you are interested.

Mr. **Mitchell**. Frankly I do not know what to say to you except that across the board in all facets of the Small Business Administration activity we are seeing more and more of this happening. In one program companies are being forced to sign a fixed participation term, which does not make any sense. In another program, companies are being forced to graduate out alleging that they are too big, which does not make any sense, given the economic difficulties that confront the Nation right now.

Like you, I would hope that the Small Business Administration would get back on track. This is my own personal statement, since I am not speaking for the committee, but it appears to me that the Small Business Administration is consistently acting in a fashion inimical to the best interests of small business, not just with regard to SBIC's or MESBIC's, but across the board. I am constrained to wonder about the commitment of an administration as represented through SBA, the commitment to small business in general. I am very sorry I cannot be more forthcoming in terms of saying, "Look, maybe we can help you get back together." I just do not think that is going to happen, but I do think that the Congress needs to know the story of SBA vis-a-vis its relationship.

Obviously I am pleased by the testimony of these gentlemen and other testimony we have heard this morning, but I do have a concern, and I would probably have to go to some of the other witnesses that we heard from earlier. It appears to me that there is an enormous tilt in the SBIC and the MESBIC program toward high technology. I have not heard the other stories: the smaller nonhightech companies who are benefiting. While I cannot quarrel with that tilt, I think high technology is the business of the future. On the other hand, there are still these other businesses out here that are part of America's lifeline. I am a little concerned about the apparent lack of involvement on the part of SBIC's and MESBIC's with those smaller operations.

I guess what I would like to do is to correspond with the presidents of both of those outfits to try and get a better picture on what is being done in terms of assistance and help to nonhightechnology firms. How many are you helping, and so forth. I worry about that tilt, primarily because, and without denigrating the efforts of either of the two organizations, a number of high-technology firms are going to succeed anyway. This is a high-technology era that we are in, and they are going to make it. I am certainly not denigrating the efforts on the part of either of the two entities, but it is almost that these entities are riding on the crest of a wave that is going up, and it is a lot easier to be of assistance in that fashion than it is to the little guy who is stagnating out there, who has good stuff to offer but cannot move.

For both Mr. Gabai and Mr. Currie, the most fascinating part of both of your testimonies is that you stood on the brink of disaster on more than one occasion. From 1977 to 1982, Mr. Gabai, it took you that long a period of time to become profitable enough to pay your taxes. I do not recall the total figure, Mr. Currie, of venture capital put into your business.

Mr. CURRIE. About $3 million.

Mr. MITCHELL. What I find so fascinating is that the private sector apparently sees the worth of an operation and, even when that operation is stagnant, starving, or threatening to go under, it still sees the potential and will continue to risk capital, hoping for the achievement of that maximum potential, which stands in sharp contradistinction to the Federal Government's efforts using Federal funds where they say: "Look, if you have not made it in 2 years, goodbye. We think you look pretty good but we are sorry, that is it."

This is really not a question to you. I guess it is one that I have to puzzle over. How can we get a better sense in the Government programs of the potential worth of businesses so that, No. 1, SBA loans are not summarily demanded to be repaid, or beyond the first 3 years that you get no further SBA loans because you had one of $100,000, your business looks good but we are just not going to let you have any more money. That is the one that I have to wrestle with. It is not your baby; it is ours on the committee, I think.

I have no further questions except a statement which is a commitment that the staff will look into your particular case. I find it almost incomprehensible. I'm being honest with you. I've been around Congress for 12 years and I've seen some very, very strange things but I, for the life of me, cannot comprehend a situation where a venture capital firm that has assisted more than 11 businesses which now have become profitable businesses would be forced out of business. Maybe there is a higher ranking intelligence somewhere which understands this convoluted thinking.

Congressman Siljander, do you have any questions?

Mr. SILJANDER. Not really, except to say, do you feel the administrators or someone had something against you? Do you have an enemy?

I agree with the Congress, and I've only been in Congress less than 2 years.

Mr. KALBACH. I've asked that myself over the past year. I don't believe so. I think that some of the actions they are taking against us, if you want to use that term, have been taken against the other SBIC's as well, and it all seems to point to an orientation away from taking any risk within the program, if you will.

Mr. MITCHELL. But that was the essence of the program.

Mr. KALBACH. They have stated that in writing. I have tons of correspondence I will be glad to provide anybody between me and the SBA.

Mr. SILJANDER. Which states what?

Mr. KALBACH. Which states that basically they don't want to fund equity-oriented SBIC's in so many words. It states that in our case we are purely equity-oriented investors and therefore we don't fit the program. In fact, last week I met with the Deputy Administrator in charge of the program. I said specifically:

"I'm leaving the program so you can tell me the truth, do you have anything against me?" I asked your question.

"No, I think you have done a fine job."

"Does a purely equity-oriented investor belong in the program?"

He said absolutely not. So that is a verbal discussion but I don't feel that I was either antagonistic to them and I don't feel they responded that way to me. I think it was simply the fact that 11 months ago the program came into totally new administration within the bureaucracy and their emphasis was one of protecting themselves instead of taking risks and they have stated that in so many words to us.

Mr. **Siljander**. Thank you.

Mr. **Mitchell**. I don't want to keep you gentlemen but is Mr. McNeish here? I'm trying not to impose on you but this thing is just so puzzling to me.

You used to be with a program in SBA. Can you help illuminate a little bit for us why this has taken place, and if you really don't want to, fine. I can understand, but it is just such an extraordinary development. I'm just trying to get some insight.

Mr. **McNeish**. It's difficult to shed illumination on sheer stupidity, Mr. Chairman.

Mr. **Mitchell**. Fine, that is all I needed to hear.

Please, go right ahead.

Mr. **McNeish**. I think Mr. Kalbach stated it very clearly. The people running the program now have simply changed their disposition toward risk. They have expressed a severe concern about the liquidation rate of SBIC debentures which numerically have increased. They have taken a posture which is partially a signal from OMB to cut your losses on credit outstanding, and to hold down allocations. That is translated regrettably, and I think mistakenly, into a nonequity orientation toward the SBIC program. It is a complete reversal of form and, I agree with you, is inherently different from and clashes with the intent of the legislation.

Mr. **Mitchell**. That was a point I was about to make.

As I recall it, there is nothing in the legislation that is prohibitive of the participation of equity-oriented venture capital.

Mr. **McNeish**. No. However, the legislation does provide the SBA with the ability to make credit determinations on extending leverage to SBIC's and they have taken a very, very conservative creditor posture, in effect something very closely akin to a commmercial bank, and that is the distinction.

Mr. **Mitchell**. Thank you. It does not help really, but in a way it does. Thank you.

Gentlemen, thank you very much for your testimony.

We are now down to our last two panelists, Brent Rider and John Douglas, chairman of the National Group Television. Mr. Rider is the immediate past chairman of NASBIC and the president of the Union Venture Corp. in Los Angeles.

Gentlemen, thank you for taking the time to be here. It is good to see you again.

I understand that your testimony is relatively brief. What I would like to do is, I will elicit the testimony from both of you and then we will go into questions. Is that right?

Mr. **Douglas**. Right.

Mr. **Mitchell**. So whoever wants to go first; I am not the wise decisionmaker; fine.

PANEL CONSISTING OF JOHN DOUGLAS AND BRENT T. RIDER

TESTIMONY OF JOHN DOUGLAS, CHAIRMAN, NATIONAL GROUP TELEVISION, SAN JOSE, CALIF.

Mr. DOUGLAS. I am John Douglas, chairman of the National Group Television.

In the fall of 1974 I initiated a systematic program to research various industries that offered growth potential and essentially zero in on the most attractive industry that matched my skills with my interests. I then commenced a search for a suitable acquisition candidate or startup situation. This resulted in the formation of National Group Television, Inc., of San Jose, Calif., this company applied to the Federal Communications Commission in 1975 for authority to activate Channel 48 to serve the greater San Jose-Santa Clara County area. When the approval was granted in 1978, we then solicited a television network affiliation. Although this did not prove successful, we did obtain a subscription television contract from a pay TV operator. Then National Group proceeded to solicit an investor group of MESBIC's.

The initial construction and operating capital totaled over $5 million and was provided by the following: $3 million from Equipment Lessors, $500,000 from Crocker Bank with an SBA guarantee; $400,000 from the STV franchise operator, and $650,000 from MESBIC investors.

The MESBIC investment of $650,000 was provided in exchange for subordinated notes and warrants. This financing was completed in early 1980, and triggered the equipment lease and bank loan. Opportunity Capital Corp. (OCC) of San Francisco acted as lead investor. The two other major MESBIC investors were Syncom Capital Corp. and Alliance Enterprise Corp. Syncom, based in Washington, D.C., specializes in broadcast investments and Alliance is a subsidiary of Sun Oil Co. In addition, Cominvest of Hartford participated in the financing. A second round of financing of $750,000 was provided to NGTV by the original MESBIC investors after the station was constructed. Channel 48, with the call letters KSTS, went on the air in May 1981. The station broadcasts with 4.4 million watts, and covers the entire San Francisco Bay Area, the Nation's fifth largest market. Channel 48 currently broadcasts 19 hours each weekday with 12 hours consisting of financial and business news. Weekend programing consists of Chinese movies, other foreign language programing, general audience programing, and religious programing until the evening, at which time subscription television [STV] programing commences. NGTV has taken over the operation of the STV programing. It now primarily consists of Japanese and Chinese programing to the approximately one-half million Bay Area orientals who are largely ignored by other bay area television stations during prime time hours.

In addition, NGTV has also accomplished the following in its brief history:

First, it produces a daily 2-minute newsbreak called "Front Page" that is syndicated on the Black Entertainment Television network, which reaches more than 2 million cable TV homes, mostly in urban areas throughout the Nation. Advertisers for "Front Page" are IBM and Mobil Oil.

Second, syndicated via satellite a daily 1-hour program called "Business Today." This program appeared in 5 million cable TV homes in 46 States, and was rebroadcasted on TV stations in New York City, Los Angeles, Chicago, Philadelphia, and San Diego. American Express, TWA and Smith-Barney were among the national advertisers.

Third, produced a special half-hour documentary shot on location in Ireland entitled "The Greening of Ireland," a look at the Silicon Valley of Europe. Advertisers included such companies as Westinghouse and Amdahl.

Also NGTV currently airs "The Minority Business Report" and "The Money Game," both produced by local black groups. It has also produced a pilot series entitled "An American Dream," a guide to starting your own small business. In Barron's magazine in a 1973 article entitled, "Minorities Market—Ethnic Broadcasters Make an Effective Pitch," a quote was made:

> While part of the increase in ethnic broadcasting reflects growing concern over U.S. minorities, it is chiefly a matter of dollars and cents. Says one broadcaster: "It's not black power or brown power—it's green power."

It is up to you gentlemen to insure that minorities are not shut out from venture capital sources, capital that is all too often missing from the equation of: "Mind plus muscle plus money, equals management plus mission."

Opportunity Capital Corp.'s foresight and initial move has provided the momentum that led a milestone event for America: The West's first television station to have black persons as majority owners. National Group Television's aim is to serve the interests and needs of all the community, and to be competitive and successful in the business world. It is with this goal that we hope to make our stand so that others may benefit and move forward.

Thank you.

Mr. **Mitchell.** Yes, thank you.

TESTIMONY OF BRENT T. RIDER, PRESIDENT, UNION VENTURE CORP., LOS ANGELES, CALIF., AND PAST CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. **Rider.** Mr. Chairman and members of the committee, I am going to depart from my prepared testimony in the interest of brevity.

My name is Brent Rider and I'm president of Union Venture Corp., a small business investment company in Los Angeles. I'm also the immediate past chairman of the National Association of Small Business Investment Companies.

I'd like to take a few minutes to talk about my own company, Union Venture. Union was licensed in 1967, and today has privately held assets of $20 million. It is 100 percent owned by Union Bank. In its 15-year history, Union Venture has invested in 67 small businesses; today our portfolio consists of 19 companies. We lean heavily toward startup and early-stage investments in high technology firms, but have also invested in such diverse industries as restaurants, furniture manufacturing, and airlines.

I'd like to now tell you about two of the companies we have invested in in recent years, one of which Gary Kalbach discussed earlier. The first of these is a company called Bradco, which is based in Orange County, Calif., and makes collators and sorters for copy machines. Less than 2 years ago it had no sales when we invested in it, but is now selling its products at a $20 million annual rate. It employs hundreds of people. Three SBIC's, and one company which gave up its SBIC license in disgust, financed it. One of these SBIC's was turned down by SBA for leverage reasons. Because of scarcity of capital, we have finally had to turn to Japan for help and in this case have an extremely helpful relationship with a Japanese company who is our partner.

The second of those companies mentioned by Mr. Kalbach in his testimony is Integrated Device Technology. It makes 16 K CMOS static random access memory chips. It was started in a station wagon in Santa Clara no less than 3 years ago.

It is the only American manufacturer of its product, the others being Hatachi and Toshiba, and our product is even better than theirs. The product is critical to the cruise missile program and to the F-18 as well as for many other military and industrial products. It was originally financed by three SBIC's and since then many millions of dollars have been invested in it and many more are needed. Yet of the three SBIC's that started it, one has decided to shut its doors, that is West Coast due to SBA policies, and another has been denied leverage by SBA.

Since we do need more money for this company, should we turn to Japan here too?

Now that I have told my war stories, I'd like to talk about regulation. We're quite proud of the fact that over a 15-year period in the program, Union Venture has had very few major violations, and certainly we have never been involved intentionally in a regulatory infraction which harmed a small firm or the SBA as our major creditor.

I believe our record tells the story clearly and directly. We've helped a substantial number of small firms grow and prosper through venture capital investment and management assistance. We've also grown and earned a fair profit for our investors in a working partnership arrangement with the SBA. This simply proves that the program can and does work well for everyone: small business, SBA, and SBIC's.

The program has been unbelievably successful at what it set out to do. Why has the SBIC program been the finest model of private-public partnership in Government?

The answer is simple. The program capitalizes on a blend of principles which have been tested over time and proven to work. The first element is the profit motive, the driving force behind America's free enterprise system. This is combined with the concept of private capital at risk, creating a risk-reward relationship which forces the program to meet the test of bottom-line realities through privately negotiated transactions.

Because an SBIC's success is totaly dependent on the success of its portfolio concerns, a market discipline is built into the system which causes the SBIC to deal fairly and equitably with small firms in its portfolio and simultaneously shields the Government's exposure to risk. Added to this is the feature of privately managed

SBIC's, allowing the industry to compete for and provide the best available talent.

The final element involves a degree of balanced but limited Government intervention, giving the SBA an ability to concentrate on program oversight with a minimal drain on scarce Federal resources.

The industry has a good record when it comes to serious, major violations. SBA's own analysis shows that when alleged violations which turned out to be nonviolations, multiple countings of the same transactions, de minimis, and merely technical violations are netted out of the gross numbers:

First, 80 percent of all SBIC's have no major violations.

Second, the rate of actual major violations per SBIC is quite small: 0.4 per SBIC.

Third, truly serious violations which are in fact detrimental to small business or to the SBA as a creditor are concentrated in a very small number of SBIC's. We estimate this to be no more than 5 percent of the industry.

In order to create and sustain this positive environment it is essential that SBA provide: one, continuity in program policy over the long term; two, a shared acceptance of financial risk as a partner in the SBIC process; and three, a reasonable and balanced approach to regulatory oversight of SBIC operations. These three building blocks provide the foundation for the program. The fact that they were effectively in place for a number of years gave the industry its opportunity to achieve the phenomenal record of success referred to earlier. Regrettably, over the past 24 months there has been an apparent effort to weaken or destroy these very foundations of the program.

The first item is policy continuity. Continuity in policy has been shattered by moratoriums and a continuing series of ad hoc policy changes applied on a case-by-case basis. SBA must recognize that the venture capital business is a long-term business. It is essential that SBIC managers be able to rely with some degree of certainty on long-term continuity in governmental policies. If that certainty disappears and SBA becomes an unreliable partner, it will simply destroy the program.

Recently, we have also witnessed a significant erosion of SBA's willingness to be a partner at risk. The application of commercial lender cash flow and creditor standards to SBIC's, indiscriminate reduction or rejection of leverage requests, blurred leverage allocation formulas, and the failure to fully utilize available leverage authority to meet demand have had a demoralizing effect on the industry. Access to long-term leverage at reasonable cost is the single most important governmental incentive to the SBIC industry. Continuation of SBA's vacillation on leverage policies would be a highly destructive course of action which ultimately will impose great harm on small growth companies in need of venture capital.

In our view, SBA seriously mismanaged the process of providing leverage to the SBIC industry during the 1982 fiscal year. During the year SBA changed the ground rules in several ways, often without notice to the industry. SBA modified its allocation formula at least twice, adding new elements related to liquidity and idle funds. In addition, we know of several situations where SBA apparently reduced leverage requests on an indiscriminate basis.

SBA also initiated, without notice or opportunity to comment, a material change in its policy on equity-oriented SBIC's eligibility for leverage. This change in and of itself resulted in the rejection of tens of millions of dollars in SBIC leverage requests. Because of these policies and continuing high interest rates, it became clear by June 1982 that there was a bulge in funds available for SBIC leverage, but SBA stuck to its restrictive course of allocation and rejection. Then at the eleventh hour—August 23, 1982 to be exact—SBA sent a memo to the industry saying there was a whopping $57 million available for the last funding of the fiscal year. That's out of the total authorization of $160 million.

Mr. MITCHELL. I hate to interrupt you, but give me that date again?

Mr. RIDER. Mr. Mitchell, it was August 23, 1982.

Mr. MITCHELL. That leaves you September and that's the end of the fiscal year.

Mr. RIDER. September 3 was the date when all the applications had to be in.

Mr. MITCHELL. The fiscal year was then effectively over?

Mr. RIDER. That's correct. That notice arrived around the last day of that month, and the third day of the next month—September 3—was the day on which board resolutions, legal documents, and financial statements had to be submitted, that is 3 days later.

Mr. MITCHELL. I'm sorry but I did not mean to interrupt you. I just wanted to be clear on that.

Mr. Rider, the net result was that SBA ended up not using over $26 million of its appropriated authority at a time when rates had dropped substantially to levels very attractive to SBIC's. In effect, SBA has denied $26 million in venture capital to small, emerging growth companies. That means, according to our calculations, between 2,000 and 5,000 jobs in an economy that the President himself says is in a hell of a mess. Bob Zicarelli pointed out the problem of a shortage of leverage for the industry during 1983 and 1984. We simply cannot afford to have a repeat of the situation where millions of dollars are not used for investments in small growth companies, particularly during these critical economic times.

The third element which is fundamental to an effective SBA-SBIC partnership is a regulatory atmosphere which is fair, reasonable, and recognizes both the realities of the venture capital process and the benefits that the private marketplace provides. Freely negotiated transactions which involve complex value judgments and risk-reward decisions are the creative force in the SBIC investment process. Any arbitrary Government intervention in these free market negotiations, or regulatory formulations which build biases in favor of one type of transaction over another, or regulatory rigidity which precludes negotiating flexibility is antithetical to and destructive of the process itself.

Unfortunately, the major elements of the original version of proposed Revision 6 violated the underlying principles of the SBIC program. SBA designed safeguards which would have produced results which were just the opposite of what was intended. In this case the results would have been fewer equity investments, and a reduction in the flow of venture capital to small growth firms. Consequently, the regulatory changes which were originally proposed represented a potential disaster for small business and the SBIC industry. One series of proposed changes would have placed SBA right in the middle of the negotiating process, setting terms usually arrived at by lengthy negotiations.

Never before in the SBIC program's history had the industry seen such a blatant attempt by the Government to interject its "invisible hand" into the process of private market negotiations. Furthermore, all these proposals and others such as those dealing with inactivity and definitions of types of financings, were clear examples of regulatory inflexibility which directly contradict the Reagan administration's stated philosophy of deregulation. Some of the changes dealing with mandatory subordination and fixed rate differentials of debt securities would have built an artificial bias into the system against venture-type financings and in favor of loan transactions, a result which appears to be at odds with the stated objectives of both the SBA and the Congress.

To the agency's credit, after a virtual onslaught of lengthy, well-reasoned objections by the SBIC industry, SBA has advised us they are withdrawing several of the most objectionable features of proposed Revision 6. They have also indicated that a number of remaining areas where there is strong industry objection are "open for discussion," and they have invited industry representatives to meet with them on these remaining issues. Bob Zicarelli has appointed a committee which will meet with SBA officials sometime in the next 2 weeks. We'll see how serious they are about meaningful change then.

Let me close my testimony with a quote from SEC Commissioner Barbara Thomas, who it seems to me is right on point. On July 7, 1981, she said:

> "Taking substantial, calculated risks to accomplish worthwhile goals has been the unique genius of the American people—encouragement of new capital formation requires a shift away from the official discouragement of risk taking which has resulted from much of the Government regulation in recent years. Although Government must protect the many from the fraudulent devices of the corrupt few, it must take care not to destroy the ingenuity and entrepreneurial spirit which it initially sought to encourage. Government cannot protect entrepreneurs from their own folly; government cannot shield investors from loss. Risk is inherent in economic activity. We cannot sterilize risk from our economy without killing the economy."

Thank you, Mr. Chairman.

[Mr. Rider's prepared statement follows:]

PREPARED STATEMENT OF BRENT T. RIDER, PRESIDENT, UNION VENTURE CORP., LOS ANGELES, CALIF., AND PAST CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT CO.

My name is Brent Rider. I am president of Union Venture Corp., a bank-owned small business investment company in Los Angeles, Calif. I am also the immediate past chairman of the National Association of Small Business Investment Companies.

I'd like to take a few minutes to talk about my own company, Union Venture. Union was licensed in 1967, and today has privately held assets of $20 million. It is 100 percent-owned by Union Bank, which because of the Glass-Steagall Act of 1933, can only become involved in venture capital through the medium of a SBIC. In its 15-year history, Union Venture has invested in 67 small businesses; today our portfolio consists of 19 companies. We lean heavily towards startup and early stage investments in high technology firms but have also invested in such diverse industries as restaurants, furniture manufacture, and airlines.

I might mention here that there is absolutely no relationship between our SBIC and the commercial loan department of the bank. Union Venture was formed for the sole purpose of making a profit for Union Bank through venture capital investing. As a separate arm of the bank, the return-on-investment of Union Venture has been excellent: 23 percent compounded.

Rather than dwell on Union Venture itself, let me tell about a few of the companies we have assisted in recent years.

I am also quite proud of our SBIC's regulatory record. As I indicated earlier, we've been in this business for 15 years, we've grown and profited. We've also lived through several major revisions in SBA's regulations, a series of continuing technical changes, several statutory amendments and an annual regulatory compliance audit by the SBA.

Have we been profitable because we disregarded the letter and spirit of the statute and regulations, or violated the regulations with impunity? The answer is a resounding "NO." We're quite proud of the fact that over a 15-year period in the program Union Venture has had very few "major" violations and, certainly, we have never been involved intentionally in a regulatory infraction which harmed a small firm or the SBA as our major creditor.

I believe our record tells the story clearly and directly. We've helped a substantial number of small firms grow and prosper through venture capital investments and management assistance. We've also grown and earned a fair profit for our investors, in a working partnership arrangement with the SBA. Throughout this period no regulatory infractions have occurred which have been detrimental to a single small firm or to the SBA. This simply proves that the program can and does work well for everyone, small business, SBA and SBIC's.

The program has been unbelievably successful at what it set out to do.

Why has the SBIC program been the finest model of private/public partnership in government? The answer is simple—the program capitalizes on a blend of principles which have been tested over time and proven to work. The first element is the profit motive, the driving force behind America's free enterprise system. This is combined with the concept of private capital at risk, creating a risk/reward relationship which forces the program to meet the test of bottom-line realities through privately negotiated transactions. Because an SBIC's success is totaly dependent on the success of its portfolio concerns, a market discipline is built into the system which causes the SBIC to deal fairly and equitably with small firms in its portfolio and simultaneously shields the Government's exposure to risk. Added to this is the feature of privately managed SBIC's, allowing the industry to compete for and provide the best available talent. The final element involves a degree of balanced but limited Government intervention, giving the SBA an ability to concentrate on program oversight with a minimal drain on scarce Federal resources.

Blending these elements into an effective, working program requires a true partnership between the SBIC industry and the SBA. The industry's obligation to the partnership involves, and SBA has every right to expect, a good faith commitment to play by the rules. We believe the industry's record in meeting this obligation has been positive. NASBIC has continuously worked for a "zero-defect" industry, has pressed for initiatives which would remove those who flagrantly and willfully violate SBA's regulations, and has cooperated with the Government in its attempts to weed out such miscreants. Unfortunately, no law however tough and no regulation however strict can root out those with larceny in their hearts, so we have witnessed several cases over the years where a criminal an embezzler or a conspirator has run off with some dollars.

NASBIC continues to spend a major share of its resources on positive efforts to minimize all types of regulatory violations.

In each year since 1975, NASBIC has conducted a weeklong management institute. One of the chief reasons for this educational program is our desire to acquaint SBIC professionals with the regulatory requirements of the program. In September of this year we had another capacity attendance of 100 SBIC executives at the 1982 management institute, and once again heavy emphasis was placed on compliance with SBA regulations.

NASBIC has covered SBA regulations at every one of its 24 annual meetings. Top level officials from SBA and our officers and staff have stressed the importance of understanding and complying with the regulations. These sessions have always been given great prominence and have been well attended. Just 2 weeks ago SBA Administrator Jim Sanders and several top level officials from SBA's Investment Division spent many hours at our annual meeting in detailed discussions of SBA regulations with our members.

In addition, our national membership is divided among six regional associations and these area groups hold annual meetings, as well as periodic workshops. At least once a year, NASBIC and SBA staff utilize these regional platforms to explain recent changes in the regulations.

Finally, NASBIC occasionally undertakes a major initiative in the regulatory area. In 1979, a blue ribbon panel of association officers spent many days in the field and in Washington exploring every facet of the current regulations and drafting a series of 50 recommendations for clarifying, streamlining, and strengthening SBA's rules for SBIC's. We submitted our report to the Administrator of SBA on March 31, 1980. Our major goal in undertaking that project was to minimize the number of violations, both through clarifying complex regulations and through eliminating those which served no useful purpose. Regrettably, some 29 months later, on August 15, 1982, SBA's digestive system disgorged the Government's version of our recommendations. It's referred to as Revision 6, and I'll discuss that in a moment.

This brings me to the SBIC industry's overall regulatory record.

As I indicated, since the program's inception NASBIC has worked very hard to achieve three basic objectives in the regulatory area:

1. To completely eradicate all "major" violations,
2. To reduce "technical" violations to an absolute minimum, and
3. To root out the few bad actors who may have slipped into the program.

Considering the nature of the venture capital business, we believe our industry's regulatory record is good. Any active, regulated financial institution aggressively pursuing business in a highly competitive marketplace may commit technical infractions. The development and negotiation of venture capital transactions does not fit neatly into a complex regulatory framework, and absolute conformity requires an enormous effort at due diligence. So technical violations do not shock or surprise me, particularly when compared with examination reports of commercial banks.

We know that the vast majority of SBIC managers are honest and reputable businessmen who are attempting to make a fair profit through legitimate business practices in a complex, fast-moving, high-risk field. We know they have a sincere respect for both the spirit and the letter of the law and regulations which govern their operations, and it is deeply disturbing to suffer misleading and unfair allegations of regulatory abuse.

The SBIC industry has been subjected to two such attacks in the last few years: one, an article in the Wall Street Journal on June 8, 1982; the other, a report by SBA's Inspector General in February of 1980. As to the Journal article, let me simply say that it was a slanted exercise in sensationalist journalism totally out of character with that paper's fine reputation. A copy of my letter to the editor repudiating the article is submitted for the record.

The Inspector General's report contained several positive recommendations which have since been incorporated into regulatory changes or improved management practices at the SBA. It too, however, was seriously misleading to the uninformed reader. That report's most serious shortcoming was the misuse of gross numbers of so-called "findings of alleged violations" as the basis for unsubstantiated allegations which reflect adversely on a total industry. These gross numbers may make good headlines, but they simply distort the real picture of how many serious violations actually take place. Moreover, the so-called "Big Six" major violation categories—which are supposed to define those infractions seriously detrimental to small firms or the SBA—is actually a misleading classification, since many of the violations captured in this net was merely technical in nature or de minimis in impact.

The industry has a good record when it comes to serious, "major" violations. SBA's own analysis shows that when alleged violations which turned out to be nonviolations, multiple-countings of the same transactions, de minimis and merely technical violations are netted out of the gross numbers:

One, 80 percent of all SBIC's have no "major" violations,

Two, the rate of actual "major" violations per SBIC is quite small (0.4 per SBIC), and,

Three, truly serious violations which are in fact detrimental to small business or to the SBA as a creditor are concentrated in a very small number of SBIC's. We estimate this to be no more than 5 percent of the industry.

The SBA also has an obligation to this partnership. In order for the SBIC industry to effectively perform its critical venture financing role, its Federal partner must provide a positive governmental environment which is conducive to SBIC's operating in accordance with commonly accepted business principles. As a recent General Accounting Office (GAO) Report on the venture capital industry concluded:

"The venture capital process is very sensitive to Government policies, rules and regulations. Industry and Government should work together to identify pertinent issues and suggest actions needed by either or both sides to create the greatest likelihood of a successful venture capital process in an environment of increasing capital supply.[1]

In order to create and sustain this positive environment it is essential that SBA provide: (1) continuity in program policy over the long term; (2) a shared acceptance of financial risk as a partner in the SBIC process; and (3) a reasonable and balanced approach to regulatory oversight of SBIC operations. These three building blocks provide the foundation for the program, and the fact that they were effectively in place for a number of years gave the industry its opportunity to achieve the phenomenal record of success referred to earlier.

Regrettably, over the past 24 months there has been an apparent effort to weaken or destroy these very foundations of the program.

The first item is policy continuity. Continuity in policy has been shattered by moratoriums and a continuing series of ad hoc policy changes applied on a case-by-case basis. SBA must recognize that the venture capital business is a long-term business. The venture capitalist is far more than a financial intermediary supplying capital to an entrepreneur. Venture capitalists seek out new markets and new technologies, entrepreneurial talents, and management resources and combine them into business opportunities that have significant growth potential. Faced with hundreds of judgmental decisions which can translate into millions of dollars gained or lost for their investors, it is essential that SBIC managers be able to rely with some degree of certainty on long-term continuity in governmental policies. If that certainty disappears and SBA becomes an unreliable partner, it will simply destroy the program.

Recently, we have also witnessed a significant erosion of SBA's willingness to be a partner at risk. The application of commercial lender cash-flow and creditor standards to SBIC's, indiscriminate reduction or rejection of leverage requests, blurred leverage allocation formulas and the failure to fully utilize available leverage authority to meet demand have had a demoralizing effect on the industry. Access to long-term leverage at reasonable cost is the single most important governmental incentive to the SBIC industry. Continuation of SBA's vacillation on leverage policies would be a highly destructive course of action which ultimately will impose great harm on small growth companies in need of venture capital.

In our view, SBA seriously mismanaged the process of providing leverage to the SBIC industry during the 1982 fiscal year. The Agency had an appropriated guaranty level of $160 million; but it was faced with a potential rollover to $63 million in maturing debentures and the prospect of heavy demand for funds from the industry. At the start of the year SBA logically placed $63 million in reserve and announced an allocation formula to distribute the $97 million balance, which seemed to be a reasonable approach. During the year, however, SBA changed the ground rules in several ways, often without notice to the industry. SBA modified its allocation formula at least twice, adding new elements related to liquidity and idle funds. In addition, we know of several situations where SBA apparently reduced leverage requests on an indiscriminate basis.

SBA also initiated, without notice or opportunity to comment, a material change in its policy toward equity-oriented SBIC's eligibility for leverage. This change in and of itself resulted in the rejection of tens of millions of dollars in SBIC leverage requests. Because of these policies and continuing high interest rates, it became clear by June of 1982 that there was a bulge in funds available for SBIC leverage, but SBA stuck to its restrictive course of allocation and rejection. Then at the eleventh hour (August 23, 1982 to be exact) SBA sent a memo to the industry saying there was a whopping $57 million available for the last funding of the fiscal year in September, and lifting the allocation restrictions. But the notice was too late. It arrived at most SBIC's during August vacations, just before the Labor Day weekend, allowing almost no time for preparation of the necessary board resolutions and legal and financial statements before the application deadline of September 3d. Yet SBA still rejected or deferred several millions in September leverage requests. The net result was that SBA ended up not using over $26 million of its appropriated authority at a time when rates has dropped substantially to levels very attractive to SBIC's.

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[1] "Government-Industry Cooperation Can Enhance The Venture Capital Process," a report by the General Accounting Office to the Joint Economic Committee of the Congress, August 12, 1982.

In effect, SBA has denied $26 million in venture capital to small, emerging growth companies. Bob Zicarelli pointed out the problem of a shortage of leverage for the industry during 1983 and 1984. We simply cannot afford to have a repeat of the situation where millions of dollars are not used for investments in small growth companies, particularly during these critical economic times.

The third element which is fundamental to an effective SBA-SBIC partnership is a regulatory atmosphere which is fair and reasonable and recognizes both the realities of the venture capital process and the benefits that the private marketplace provides. Freely negotiated transactions which involve complex value judgments and risk/reward decisions are the creative force in the SBIC investment process. Any arbitrary Government intervention in these free market negotiations, or regulatory formulations which build biases in favor of one type of transaction over another, or regulatory rigidity which precludes negotiating flexibility is antithetical to and destructive of the process itself.

Unfortunately, the major elements of the original version of proposed Revision 6 violated the underlying principles of the SBIC program. In an ostensible effort to protect small concerns, SBA had proposed to build a series of artificial regulatory "safeguards" into the process by which deals are structured. This shortsighted exercise in paternalism by SBA would have repeated the same mistake of every previous well-intentioned effort by government to intervene in the free enterprise system. Unable to properly perceive the real-world business implications of its zealous attempts to "do good," SBA designed safeguards which would have produced results which were just the opposite of what was intended. In this case the results would have been fewer equity investments, and a reduction in the flow of venture capital to small growth firms.

Consequently, the regulatory changes which were originally proposed represented a potential disaster for small business and the SBIC industry. One series of proposed changes would have placed SBA right in the middle of the negotiating process. Setting terms usually arrived at by lengthy negotiations. These included: (1) the establishment of an artificially-set differential rate on so-called debt securities which has no relationship to market assessment of risk; (2) an unsupported and arbitrary increase in minimum maturity periods; (3) the mandatory subordination of debt securities to all other creditors; (4) a unilaterally imposed and mandatory requirement of reciprocal redemption rights; (5) the governmentally-dictated ceiling on potential yields from the exercise of redemption rights; and (6) a confused, ambiguous and misleading definition of cost of money.

Never before in the SBIC program's history had the industry seen such a blatant attempt by the Government to interject its "invisible hand" into the process of private market negotiations. Furthermore, all these proposals and others such as those dealing with inactivity and definitions of types of financings, were clear examples of regulatory inflexibility which directly contradict the Reagan administration's stated philosophy of deregulation. Some of the changes dealing with mandatory subordination and fixed rate differentials of debt securities would have built an artificial bias into the system against venture-type financings and in favor of loan transactions, a result which appears to be at odds with the stated objectives of both the SBA and the Congress.

To the Agency's credit, after a virtual onslaught of lengthy, well-reasoned objections by the SBIC industry, SBA has advised us they are withdrawing several of the most objectionable features of proposed Revision 6. They have also indicated that a number of remaining areas where there is strong industry objection are "open for discussion," and they have invited industry representatives to meet with them on these remaining issues. Bob Zicarelli, has appointed a committee which will meet with SBA officials sometime in the next two weeks. We will see how serious they are about meaningful change then.

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NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
618 WASHINGTON BUILDING • TELEPHONE (202) 638-3411
WASHINGTON, D. C. 20005

June 11, 1982

The Editor
Wall Street Journal
22 Cortlandt Street
New York, NY 10007

Dear Editor:

The Small Business Investment Company program was seriously misrepresented in your article "Small Business Loans Aid 'Minority' Whites, The Rich, a Porn Film" (June 8, 1982). I would like to set the record straight.

Small Business Investment Companies (SBICs) are privately-organized and privately-managed investment companies that provide venture capital and management assistance to new and growing small businesses. They are licensed and regulated by the Small Business Administration. All SBICs are capitalized with private funds; after this money has been used to finance small businesses, SBICs can borrow additional investment capital from the Federal Government. They pay fully the cost of money to the Treasury plus a small premium for these borrowed funds.

Since the program was created in 1958, some 48,000 small concerns have received SBIC assistance. Today, over 360 SBICs with assets of more than $1.5 billion are actively engaged in the financing of growth companies. More than $333 million was invested by SBICs in calendar 1981; indications are that this financing record will be broken in 1982.

Your reporter was aware that there are currently over 10,000 small concerns in SBIC portfolios, yet he focused exclusively on a handful of investments with sensational overtones. There are thousands of good examples of successful young growth firms actively developing new products and new technologies, adding new jobs and paying more taxes. An independent study by Arthur D. Little, Inc. and Deloitte, Haskins & Sells found that SBIC-backed firms had growth rates ten times as great as other small firms in key areas such as sales, profits and employment, and five times as great in Federal tax payments. Another analysis showed that the actual cost to the Federal Government of creating a permanent job through the SBIC program is only $312, compared to an annual cost of over $20,000 in other Government programs.

BEST COPY AVAILABLE

In spite of detailed and complex regulations that govern every aspect of SBIC operations, and efforts by the industry's leadership to promote compliance, certain regulatory violations do occur. This is not unusual in an industry as active and diverse as ours. All SBICs are subjected to annual regulatory compliance examinations, comparable in scope to those of commercial banks by Federal banking authorities. SBA's own studies show that 95% of all SBICs have excellent compliance records; however, the agency is well equipped to take remedial enforcement action against those few SBICs that fail to operate within the rules.

All investors, regardless of personal wealth, put their own money at risk when they enter the SBIC program. The SBIC owner must lose his entire investment before the Government is subjected to a penny of loss. Furthermore, the SBIC owner can only profit if the small concerns in which his company invests are profitable, since the law mandates that the SBIC remain a minority shareholder. The "idle funds" criticized in the Journal article represent the type of liquidity any soundly managed financial institution would maintain — funds earmarked for outstanding commitments, escrowed dollars to cover guaranties, money for follow-on investments in current portfolio companies and cash operations and overhead costs.

A final note — the SBIC program itself is a profitable investment for the Federal government and the American taxpayer. A second study by Deloitte, Haskins & Sells found that Uncle Sam spends only $4 million annually to run the program (administrative costs and losses) and in return receives $440 million in increased tax payments from SBICs, their portfolio companies and their employees — a benefit/cost ratio of 110 to 1.

In summary, at a time when economic growth, jobs, and the development of new technologies are vital to the future of our country, your paper has done a disservice to an industry which provides essential seed capital to growing small firms.

Sincerely,

Brent T. Rider
President, Union Venture Corporation

Chairman, National Association of
Small Business Investment Companies

Mr. MITCHELL. Thank both of you. I am thinking seriously about not having any more field hearings. We start out in the morning on a very positive note of accomplishments and as the day goes on I get this enormous feeling of letdown. I must be quite frank with you: your testimony and the testimony of the other witnesses has been just devastating.

As I said, I don't understand it, but I will quickly add, one of the things about the House Small Business Committee is that we truly try to attack problems on a bipartisan basis. I think I can speak without any hesitancy or equivocation, the minority side and the majority side our staffs have to get into this business.

These latest changes, the mistakes that have been made, and I advisedly call them mistakes because they have been. Once you are forced out of business that's a mistake and I don't see any problem at all with a bipartisan staff approach to dig into this and advise both the subcommittee and the full committee on this.

I guess while I was listening to your testimony in particular I was thinking about a book that I read called, "Something of Value." It is a terrible book. It really was an apology for British colonialism on the African continent, but that title stuck in my mind. If I followed your logical conclusion, what I have heard, it's clear that some SBIC's and MESBIC's are going to be forced out unless these policies are checked. I raise the question: What are they proposing of value to replace you? What do they propose to do to insure that more and more businesses will have access to venture capital? I see nothing, absolutely nothing.

I really don't have any questions. You have given us some work to do and we are going to do it. We have got to find out what is behind this, what's the rationale? But the thing that always perplexes me when I approach these agencies, not just SBA but others, on the rationale for some of these moves is that they can't give it.

Let's give it a stab, will you gentlemen?

Congressman Siljander.

Mr. SILJANDER. The only thing I would add, Mr. Chairman, I find some of the statements made incredible, I can assure you from my standpoint, Mr. Chairman, that I am interested in seeing both sides of the story and hearing from the SBA as well. We have heard from you and again I think it's amazing, the things that have been brought up, the accusations that have been made, the seeming blunders that have caused the loss of jobs and economic distress.

Assuming those things are correct, I think I can speak from our end because I want to know why and as the Chairman said, assuming this is correct or any part of it is correct, who is the cause of the problem? What is the politics behind it? We were chatting. We want to know the politics behind it. I don't know offhand. I can only fathom. I suggest we look into it. I want to followup. I am sure the Chairman, if he says so, will do it.

Mr. MITCHELL. I sure will. Thank you for your cooperation.

Just one statement to you, Mr. Douglas. You have succeeded already and you are going to go right on succeeding to the top. You are going to be real big in a few more years. Will you then join an SBIC or MESBIC putting up some venture capital?

Gentlemen, thank you very, very much. I think we have heard from all of the witnesses. It has been a very significant and informative session for me and I thank you for your cooperation and with that, the hearing is now adjourned.

[Whereupon, at 2:20 p.m., the subcommittee adjourned to reconvene subject to call of the Chair.]

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